A Fresh Start

Report to

the Treasurer of Ontario

the Chairman of Management Board of Cabinet

and the Minister of Education

on Teachers' and Public Servants' Pensions

Dr. David W. Slater

Public Sector Pensions Consultations

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ISBN 0-7729-4451-2

Printed in Canada

Ontario

Public Sector Pensions Consultations

Caisses de retraite du secteur public - Consultations

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July 22, 1988

The Honourable Robert F. Nixon,
Treasurer of Ontario
The Honourable Murray Elston,
Chairman of Management Board of Cabinet
The Honourable Chris Ward,
Minister of Education
7th Floor
7 Queen's Park Crescent
Toronto, Ontario
M7A 1Y7

Dear Messrs. Nixon, Elston and Ward,

In accordance with the terms of reference approved and ordered on February 18, 1988, I am pleased to submit my Report.

Yours sincerely,

David W. Slater

Dr. David W. Slater
Special Advisor

TABLE OF CONTENTS

Preface i

Executive Summary

List of Background Papers

CHAPTERS

1. Past and Present Arrangements 1
2. Proposals for Change Affecting the Teachers' and Public Servants' Pension Plans 9
3. What Was Said 21
4. On Our Own Initiative 40
5. The Issues and Strategies 56
6. Options 73
7. Conclusions and Recommendations 86

APPENDICES

A. Terms of Reference A.1

B. List of Organizations and Individuals Submitting Briefs B.1

C. List of Visits We Initiated C.1

D. Consultations Seminar: Program and List of Participants D.1

E. Interest Rates on the TSF/TSAF and PSSF/PSSAF E.1

Glossary

PREFACE

Introduction

This is the report of the Public Sector Pensions Consultations carried out by Dr. David W. Slater for the government of Ontario between February and July, 1988. The Order in Council establishing the Consultations and setting its terms of reference and general procedures is set out in Appendix A. We examine:

- The pension plans of the teachers and of the public servants.

- The recommendations for major changes in these plans, particularly as they were set out in:
  - The Rowan Report: In Whose Interest? The Task Force on the Investment of Public Sector Pension Funds;
  - The Coward Report: On the financing of indexed pensions under the Public Service Superannuation Act (PSSA), the Teachers' Superannuation Act (TSA) and the Superannuation Adjustment Benefits Act (SABA).

Subject of Consultations

Against this background we were asked to carry on consultations and report to the Treasurer of Ontario, the Chairman of the Management Board of Cabinet and the Minister of Education on, briefly:

- Benefits of changes in funding.

- Merging the basic funds with related adjustment funds.

- Future direction of changes in pension plan design.

- Investing pension funds in marketable securities.

- Separate pension funds governed at arm's length from the government.

The Consultations

Among the processes and precepts which guided the Consultations, the significant ones were:

- The report is limited to the teachers' and public servants' pension plans. Other public and private sector pension programs were examined for the lessons that could be learned regarding the issues now arising for plans which are the primary subject of the Consultations.

- The Consultations were directed to all interested parties by solicitation of briefs, discussions, seminars and reviews of research. Participation was generously provided by many individuals and representatives of organizations.

- The Consultations were conducted in a broad and unfettered mode. The government did not set any limits on the range of funding options, structure, plan design, investment portfolio, governance of the plans.

- Views are specifically attributed to organizations and persons with careful regard for 'on the record' positions. A good deal of 'background' information and advice was sought and offered with both interest and goodwill. This advice permitted us to interpret the mood, the setting, the problems, the probable directions of negotiation; but on our own responsibility, rather than for specific attribution.

- There are considerable differences concerning the facts, interpretations and recommendations among the participants in the pension plans, their representatives and the public.

- ***There is also a large measure of goodwill and interest in finding sound, viable bases for the future pension plans.***

- The purpose of the Consultations is to find as much common ground as possible, to explicate the differences and to suggest approaches that have the potential to assist in the future negotiations of the pension programs of the teachers and public servants in Ontario.

Acknowledgments

In the Consultations we received contributions from a large number of representatives of organizations and from many individuals. They are listed in Appendices B, C, and D.

We express our deepfelt thanks for this co-operation. Without such generous and frank contributions, it would not have been possible to provide the ministers with possible solutions to the problems of the pension programs of teachers and public servants.

We were served by a small secretariat through the Public Sector Pensions Advisory Board. We thank that body for its help, particularly that of Kimberley Hopps who was the chief assistant to the special advisor and Jane Grier who was the coordinator of the Consultations.

We believe that a core of agreed positions has emerged. When differences arose, they were presented constructively and reasonably. We are grateful for these approaches which made the Consultations more effective. We hope that the report has captured these moods.

EXECUTIVE SUMMARY

❐ Introduction

The government has released two reports, the Rowan report and the Coward report, which propose sweeping and radical changes in teachers' and public servants' pensions. Decisions must be made about whether, and how, to implement the changes in the two reports. Negotiations will have to take place between the government and representatives of the teachers and public servants. Agreements for change will require the support of the participants and the legislature. The proposals from the reports are:

- To place the indexation programs, as well as the basic programs, on a fully-funded and secure basis, and to merge the indexation funds with the respective basic funds.
- To substantially increase contribution rates to meet the funding objectives.
- To retain current benefit and inflation protection levels.
- To make some improvements to comply with pension reform.
- To invest the pension funds in marketable assets.
- To place the pension program on an arm's length basis to the government.
- To increase the level of formal plan member involvement.
- To have the government pay the costs of the large unfunded liabilities for pension rights arising from past service.

Acceptance of some or all of the Rowan and Coward report proposals would have large and immediate impacts on all teachers, public servants and taxpayers. The proposals would be especially significant for contribution rates. In addition, the funds would be improved by paying the SAF unfunded liabilities.

We were asked to consult widely to hear informed and representative views about the proposals, to find as much common ground as possible, and to suggest approaches which could help in the future negotiations for change.

We sought submissions and advice from a broad range of groups and individuals including all of the major bodies representing teachers and public servants, individual teachers and public servants, pensioners, the general public, and business, financial, academic, actuarial and benefits consulting communities.

We addressed all the proposals under consideration, with particular attention to the trusts and trusteeship; the issues of sharing program rewards and responsibilities; benefits, contributions and plan design; fund investments; and the advantages of changing the funding and merging the basic funds with the indexation funds.

The Consultations carried out by Dr. David W. Slater have been submitted to the Honourable Robert F. Nixon, Treasurer of Ontario, the Honourable Murray Elston, Chairman of Management Board of Cabinet, and the Honourable Chris Ward, Minister of Education.

❐ The Necessities

Important factors combining to underline the urgency for making changes now include:

- Even under the best conceivable circumstances, current contribution rates and available assets will be insufficient to pay for the indexation of pension benefits levels now in place. This financing difficulty applies to both pension benefits which will arise from future service and those already earned.
- Considerable mistrust, doubt and scepticism exists about teachers' and public servants' pension matters. Unless there are major improvements in the consensus on pensions, it is possible serious deterioration in labour relations could take place.
- The Friedland report's inflation protection recommendations for employment pension plans are in play and must be considered as they relate to teachers' and public servants' pensions.
- The pension benefits act, 1987 requires substantive pension changes, particularly in the areas of vesting, portability of benefits, and survivor benefits.
- Further changes may be imposed as a result of the proposed federal income tax act changes for pensions, savings and other retirement income programs.
- The schedule of future CPP contribution rate increases may impact on the amount people are willing, or able, to pay for their employment pension programs.

- Canadian Institute of Chartered Accountants (CICA) accounting standards proposed for public sector pensions may affect the public accounting, and perhaps the substance, of teachers' and public servants' programs.

❒ The Opportunities

Factors creating opportunities for a fresh start include:

- The issues are now in the open. Careful up-to-date analyses of the situations are now available. The understanding of the problems and discussion of possible solutions have increased, although much misunderstanding still persists.
- A "window of opportunity" exists over this year and next to assist in making long-term substantive changes in the nature of the pension deals. In addition there is a great sense of urgency about the importance of addressing pension issues since the plans must open up their acts to address pension reform before January 1, 1990.
- The Coward and Rowan report recommendations would introduce sweeping and innovative changes and, although there is far from a consensus on all the facts and their interpretations, there does appear to be a starting point for reaching consensus on alternative solutions.
- The philosophy is changing about plan participants and their involvement in pension trusteeships and their sharing in program rewards and responsibilities. Plan participants are showing greater interest in having formal input into their pension programs. As a result, we believe that there is a trend towards greater plan member involvement in running pension plans and we think that this trend will continue to grow. This belief seems to be shared by many employees and employers. Well-established networks and organized bodies representing employees exist to further facilitate this trend.
- After many years of relatively low investment earnings, both the teachers' and public servants' pension funds now earn good average rates of investment return which can be used to facilitate the proposed transformations.
- With inflation lower and more stable than in recent history, the opportunity for making more temperate resolutions of the longer term pension issues now exists.

❒ The Report

The Consultations report is divided into seven chapters and a short description of the focus of each chapter follows.

Chapter 1: Past and Present Arrangements is a summary of the existing pension arrangements.

Chapter 2: Proposals for Change Affecting the Teachers' and Public Servants' Pension Plans is a review of important reports that are especially pertinent to the Consultations, primarily the Rowan and Coward reports. Other sources include the Friedland report on approaches to mandatory inflation protection of employment pensions; the Pension Benefits Act, 1987; the proposed changes in the Federal Income Tax Act regarding savings and pensions; and the proposed accounting standards in the Canadian Institute of Chartered Accountants (CICA) for public sector pensions.

Chapter 3: What Was Said is a summary of what we were told in submissions and in related discussions. The chapter is not intended to editorialize and any attributions have been reviewed and agreed to by the representative bodies. Submissions made to us are public information and available upon request.

Chapter 4: On Our Own Initiative reports on what we learned through discussions and reviews initiated by us. Our primary interest was to learn from the experience of others about the issues and solutions pertinent to the proposed changes for the teachers' and public servants' pension programs.

A message of particular significance is that there is a great deal of Canadian experience in both the public and private sectors, in successfully coping with all of the issues related to the proposed transformations. Such extensive and successful experience gives a great deal of reassurance about the ability of the teachers' and public servants' programs to cope with the issues.

Chapter 5: The Issues and Strategies outlines nine issues that must be resolved in order to work out reform of the pension programs. Some comments are made, solutions suggested and impressions of the attitudes of employee representatives described.

The issues to be resolved in working out a fresh start relate to:

- Trusts and trusteeship
- Relationships to collective bargaining
- Process of monitoring and change
- Self-contained and self-sustaining programs
- Market investments
- Contribution rates basis
- Basic and inflation protected benefits
- Past service unfunded liabilities
- Minimum requirements

We believe that while all of these issues apply to both the teachers' and public servants' programs they can be resolved differently to meet unique and different needs. We do not subscribe to the belief that all pension programs should be copies of one another but rather promote shaping them to meet the particular needs and concerns of both plan members and employers.

Chapter 6: Options sets out the main choices in taking and sharing responsibility for the pension programs and the nature of these deals. Underlying the options presented is the understanding that it is the government and the teachers'/public servants' representatives who must finally decide on the new programs on behalf of taxpayers and plan participants. The chapter includes:

- A spectrum of responsibility and reward sharing choices, specifically, full partnership and joint trusteeship, limited partnership and reformed status quo.
- A review of the main choices that must be made in determining the reformed pension deal.
- A review of options based on the Coward recommendations.
- Recommendations about using earmarked start-up funds - transitional and investment reserves to place the future programs on a positive footing from the start of their transformation.
- An outline of the practical funding options and comments on these choices.
- Remarks on the necessity for and effects of balancing costs, benefits and income in sound pension programs.
- The amortization of and responsibilities for the SAF unfunded liabilities.

Chapter 7: Conclusions and Recommendations describes what policies have strong support, weak or mixed support, or general opposition. We give our views on a proposed "new deal package" and suggest a checklist of alternatives in shaping choice. Although we make some particular recommendations for both the teachers' and public servants' pensions, we stress that it is up to the negotating principals to determine the nature of the changed pension programs.

Proposals With Strong and Broad Support

- Transformation of the programs into institutions at arm's length to the government and plan participants.
- Achievement of greater and more formal participation and responsibility for sharing than exists for plan participants.
- Retention of current benefit and indexation levels.
- Create the opportunity to better meet the needs of plan members who are least well-served by the existing pension programs.
- Transform the investment portfolios into diversified market portfolios which accept, at the least, low investment risk and perhaps moderate risk.
- Have some degree of risk/reward sharing that is explicitly decided. The decisions should clearly determine the proportions of sharing for both investment and experience variations from established targets. There is wide but not universal support for full sharing of the risks and rewards under an institutional arrangement of full partnership and joint trusteeship.

Proposals with Mixed or Lukewarm Support

- Consideration to moving away from a plan that is of a defined benefit design to other design choices. For example, a "hybrid" design which has both defined benefit and defined contribution elements. While "hybrid" designs, or others, may become more attractive in the future, there is not much enthusiasm for making such changes at this time.
- Teachers' organizations particularly have little enthusiasm for immediately merging the indexation funds and the basic funds. Merging does not appear to be opposed in principle but the argument appears to be that merging should only be considered when the indexation funds are mature and the returns from the new investment policies can be taken into account.
- Although there is fairly general acceptance that pension programs should become self-contained and self-sustaining, and even that risk/reward sharing should be explicit and substantial, there is some reluctance by plan participants to give up the government guarantee.
- Although the majority of employee representatives argue that employees own pension plan surplus, the Coward and Rowan reports take somewhat different positions and the legal research for the Friedland Task Force is ambivalent about the matter.

Proposals With Widespread General Opposition

- Building in excessive safety margins in pension programs.
- Introduction of large immediate increases in contribution rates for little or no improvement in benefits.
- Introduction of an overly rigid, complex and unrealistic integration of pension matters into total compensation packages.
- Imposition of a large measure of past service unfunded liabilities onto current contributors.

We strongly support the view that the government and plan members must determine the nature of the pension package and believe that our proposal can be a starting point for negotiations. Variations on this package are real choices.

Underlying our proposal is the belief that any new deal would be a fully-shared, self-sustaining risk/reward pension program. Our proposal should provide a reasonable prospect for keeping the contribution rate increases to about one per cent each side, net of reform. We support full funding of future service pension liabilities, including contractual indexing. Our recommendations for a new package include:

- Commit to full partnership and joint trusteeship. The board of trustees should be equally represented by the participants and the government.
- Negotiations are completely compatible with pension matters. However they must be done in ways that are consistent with the responsibility of the board of trustees.
- Further, firm processes must be established to ensure periodic review of the fundamental soundness of the programs. We suggest a "principals' review board" be formed with the power to impose interim adjustment programs to maintain the financial soundness of the program. Such a board should be equally represented by the participants and the government.
- A deadlock-breaking mechanism for the board of trustees and the "principals' review board" must exist.
- Retain the current benefit and indexation levels.
- Share risk/reward equally between the government and the participants as agreed.
- Create the environment for successfully bringing together the respective basic and inflation adjustment programs.
- Value, cost and determine contribution rates on a "best estimate/realistic" basis.
- Design the programs so that actuarial assumptions will provide modest cushions against adverse circumstances in the plan.
- Invest the funds in the marketplace and accept a "modest-risk - modest-earnings" target for the investment fund portfolios.
- Establish a start-up fund and investment reserve fund for each program to set the new arrangements on a sound and vigorous basis at the beginning of the transformation.
- The government should accept the responsibility for the past service unfunded liabilities related to the SAFs and enter into an amortization program to pay them over a period of 15/25 years.

LIST OF BACKGROUND PAPERS

Report #1:	Choosing the Real Interest Rate to Value Fully Indexed Pensions Professor James E. Pesando
Report #2:	Linking Pension Benefits, Pension Finance and Pension Investments Together Keith P. Ambachtsheer
Report #3:	Public Servants' and Teachers' Pension Plans: Cost and Risk Sharing Options Shiraz Y.M. Bharmal
Report #4:	The Friedland, Rowan and Coward Reports: Comparisons, Contrasts and Commentaries David W. Conklin
Report #5:	The Pension Benefits Act, 1987: Implications for the Public Sector Pensions Consultations David W. Conklin
Report #6:	The Friedland Report: A Synthesis and Commentary David W. Conklin
Report #7:	Primary and Secondary School Teachers' Salaries in Ontario: A Public/Private Sector Comparison Douglas Auld and Harry Kitchen

Chapter 1

Past and Present Arrangements

SECTION I

❐ *The 1975 Reform*

Prior to 1975, teachers and public servants each had a single pension fund. Regular matching contributions were provided to these funds by the employees and the Ontario government. In addition to matching the employee contributions, the government provided supplementary funding wherever the actuarial calculations indicated that these were necessary in order to ensure full and complete funding of the promised pension benefits.

Apart from these arrangements, the government gave ad hoc pension increases to retirees in response to inflation. These were not made automatically, or consistently. The increases were paid out of the government's consolidated revenue fund. In January, 1971, a retroactive adjustment was made to retirees to recognize inflation experienced from 1950 through 1969. A further two per cent per year was granted in 1973 in light of inflation experienced through 1971.

The government established a Task Force on Pension Escalation in 1973, "to recommend the most effective method of providing protection against inflation to retired employees from the Ontario public sector, and the means by which this may be achieved" (Field, "Summary", p.1). This Task Force recommended that:

- Inflation adjustments should be provided automatically rather than on an ad hoc basis, and that these adjustments should provide 100 per cent inflation protection.
- A new pension fund should be created to provide these automatic adjustments.
- Both the employees and the government should contribute at the rate of one per cent of salary.
- Apart from this fund, the government should pay all costs of the earlier ad hoc adjustments.

The Task Force recognized that the matching one per cent contributions would not be adequate to pre-fund the recommended 100 per cent inflation protection. But it felt that the "modified pay-as-you-go" funding for inflation protection would be acceptable at that time. In accordance with this view, the Task Force recommended that the Pension Benefits Act (PBA) be amended immediately to permit "modified pay-as-you-go" financing for the contractual escalation payments. The government accepted these recommendations, and, in 1975, passed "an act to provide Superannuation Adjustment Benefits (SABA)".

This Task Force calculated that with one per cent matching contributions, the Public Service Superannuation Adjustment Fund (PSSAF) would enter a deficit position by 1986 and the Teachers' Superannuation Adjustment Fund (TSAF) would enter a deficit position by 1983 (Field, p. 12). In fact, the assumptions used in the Task Force calculations were unduly pessimistic.

SECTION II

❒ *The Teachers' Superannuation Plan/Fund (TSF)*

The teachers' pension plan which finances the basic unindexed pensions, includes teachers in the public school system and some teachers working in community colleges and private schools. As of December 31, 1985 there were 138,620 teachers contributing to the plan, and 27,243 retirees were receiving pensions from it. There is no single overall employer. Rather, the employers are some 361 boards of education. The government of Ontario acts as the employer for pension purposes for the teachers in the public schools. The Ontario Teachers Federation (OTF) with its five affiliates formally represents the TSF members in any pension discussions with the Ontario government. Approximately 82 per cent of the teachers participating in the TSF are members of the five employee organizations which are represented by the OTF:

- l'association des enseignantes et des enseignants franco-ontariens,
- the Federation of Women Teachers' Associations of Ontario,
- the Ontario English Catholic Teachers' Association,
- the Ontario Public School Teachers' Federation,
- the Ontario Secondary School Teachers' Federation (Rowan, p. 131).

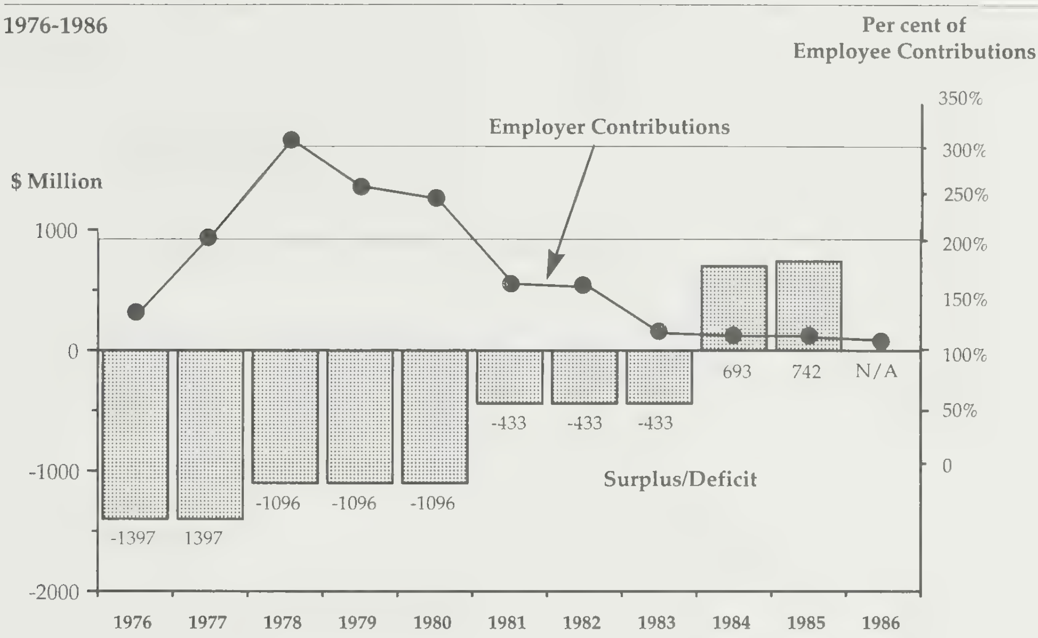
Contributions to the TSF are made by the provincial government (and by non-school board employers directly), and by teachers, with each contributing approximately 6.9 per cent of salary. This contribution rate includes the required contribution to the Canada Pension Plan (CPP). Prior to September, 1984, the matching contribution rate had been six per cent of salary. A new Teachers' Superannuation Act, 1983 (TSA) instituted several changes which became effective in September, 1984. Together with the increase in contribution rates, these include a change in the formula for calculating the pension (from the best seven years salary to the best five years salary), higher interest on death benefits, buy-backs for business experience, removal of time limits on these buy-backs, pensions for position sharing and improved early retirement provisions.

The pension benefit is based on the number of years of service multiplied by two per cent and this percentage is, in turn, multiplied by the employee's average salary in the five years of service with the highest earnings. The TSF is integrated with the CPP in regard to benefits as well as contributions. The pension calculated in accordance with the formula includes the CPP payments. The TSF itself provides only the net amount. That is, it provides the difference between the pension calculated in accordance with the formula and the amount of any CPP payments.

Each year from 1966 to 1983 the TSF experienced a long-term funding deficit. In each year, the matching contributions by the employees and employer were not adequate to fully fund the promised pensions. Each year, the government contributed additional payments to cover these funding deficits, the amounts required being determined by each triennial valuation of the fund. In 1984 and 1985, the actuarial projections indicated that the fund was more than sufficient to meet the funding conditions of basic unindexed pension obligations of the TSF. Therefore, the government was not required to make additional payments to the fund above its matching 6.9 per cent contribution.

The act does not state who owns a surplus. In practice, the 1984 and 1985 surpluses have been shared, in that part was applied to eliminate an unfunded liability and part was used to fund an early retirement program. Surpluses have accumulated in subsequent years. The following figure from the Rowan report indicates this deficit/surplus experience and the extra contributions made by the government to fund this plan.

❐ *Comparison of the TSF Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions* (Figure 7.8, Rowan p.135)



Source: Public Sector Pensions Advisory Board Staff and Teachers' Superannuation Commission

In 1984, the legislation was changed to require that all participating employers, such as private schools, must pay their share of supplementary contributions if funding deficits arise. They were previously made by the government. In view of the 1984 and 1985 surpluses, no supplementary contributions have been required.

The Treasurer of Ontario is the custodian of the TSF. As of December 31, 1986 the TSF had assets with a book value of $10.1 billion and an imputed market value of $11.1 billion. It is expected that the book value of the TSF will grow to $15.67 billion by the end of 1989.

The Teachers' Superannuation Commission (TSC) administers the plan; it has five elected teacher representatives (one from each of the five affiliates of the OTF), and five government or employer representatives (appointed by the Minister of Education). The legislature has required that the assets be invested in non-marketable province of Ontario debentures of 20 to 25 year maturities. The interest rate and term are determined by the Treasurer, in consultation with the TSC. The interest rate on each new issue of debentures has been determined since 1972 by a formula based on market rates on long-term provincial and equivalent bonds.

The education act does not permit collective bargaining in regard to the teachers' pension benefits. While there is no collective bargaining of pensions, a joint government - OTF committee has held formal detailed discussions over the past ten years, with essentially equal participation by government representatives and the OTF. Any changes in the pension arrangements would require changes in the act or regulations governing the teachers' plan.

SECTION III

❒ *The Public Service Superannuation Plan/Fund (PSSF)*

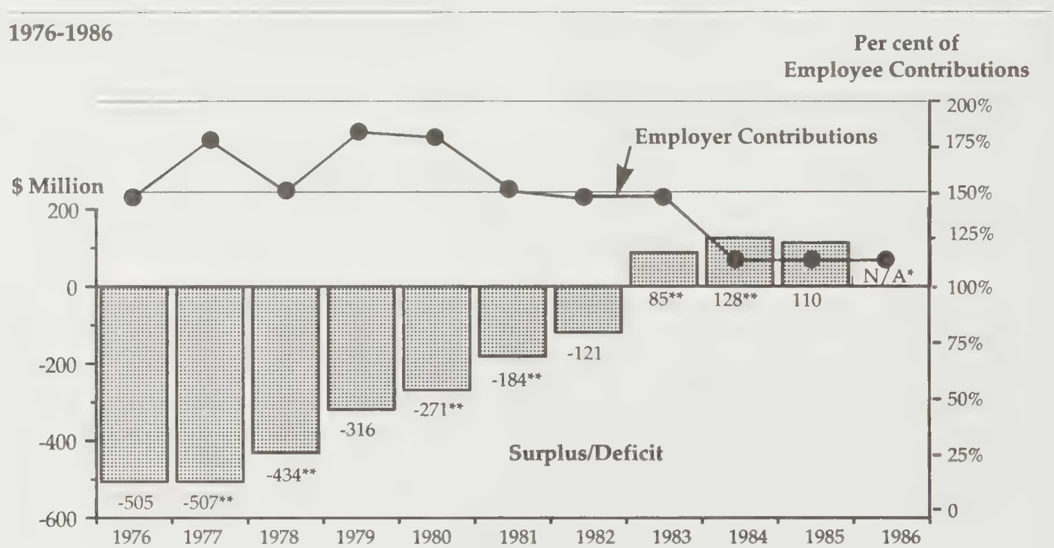
The pension plan includes employees of the province as well as employees of 32 provincial boards and commissions. As of December 31, 1987 there were 81, 378 public servants contributing to the PSSF and 24,716 pension allowances being paid. Close to 75 per cent of the employees are represented by the Ontario Public Service Employees Union (OPSEU). Smaller numbers of employees are represented by the Ontario Provincial Police Association (OPPA), the Canadian Union of Public Employees (CUPE), and the Ontario Liquor Board Employees Union (OLBEU).

Contributions to the PSSF are approximately six per cent of salary for each of the employer and employee, adjusted for CPP contributions. These contribution rates are lower than those of the TSF because of such differences as the demographic composition of the employee group, membership requirements, average length of service and average salaries.

The benefit formula is similar to that of the TSF. The pension benefit is based on the number of years of service multiplied by two per cent, and this percentage is multiplied by the employee's average salary in the five years of service with the highest earnings. As in the case of the TSF, the contribution rate and the benefit formula are integrated with the CPP. The PSSF provides the difference between the pension calculated in accordance with the formula and the amount of any CPP payments.

Each year from 1976 to 1982 the PSSF. experienced a funding deficit and the government contributed additional payments. In each of 1983, 1984, and 1985, the PSSF experienced a current actuarial surplus. Therefore, following the triennial valuation in 1985 for December 31, 1983, the government was not required to make additional payments to the fund above its matching six per cent contribution. The following figure from the Rowan report indicates this deficit/surplus experience and the additional contributions made by the employer.

❒ *Comparison of the PSSF Surplus (Deficit) and the Employer Contributions as a Percentage of Public Servant Contributions* *(Figure 8.5, Rowan p.155)*



* 1986 actuarial valuation not available
** Informal interim valuations

Source: Public Sector Pensions Advisory Board Staff and Human Resources Secretariat

The Treasurer of Ontario is the custodian of the PSSF. A Public Service Superannuation Board (PSSB), makes recommendations in regard to the administration of the PSSF and administers details of the plan, such as determination of individual benefits. The Board consists of four members appointed by the Lieutenant Governor in Council. One must be a representative of the Civil Service Commission and one must be a representative of OPSEU.

As of December 31, 1986, the PSSF had assets with a book value of $4 billion and an imputed market value of $4.8 billion. The legislature has required that the assets be deposited in non-market government debt in the form of deposits in the accounts of the province.

Interest is to be credited at a rate determined by the Lieutenant Governor in Council, on the advice of the Treasurer. Since 1972 the interest on the new deposits has been based on a formula linked to market rates on long term provincial and equivalent bonds. The PSSF currently holds approximately 13 per cent of the Ontario government debt.

The Crown Employees Collective Bargaining Act prohibits collective bargaining for public service pension benefits. However, although there have not been formal negotiations, recent discussions have been held between OPSEU and the government in regard to the pension arrangements. These discussions have not been as detailed or formal as those that were held with the teachers.

The act does not state who owns a surplus if it arises. The employers' obligations in regard to special contributions to amortize unfunded liabilities are eliminated if the fund is in actuarial surplus after a triennial valuation. Any changes in the pension arrangements would require changes in the Public Service Superannuation Act (PSSA) or regulations.

SECTION IV

❒ *The Superannuation Adjustment Fund (SAF)*

As noted, the Superannuation Adjustment Funds (SAF) are "modified pay-as-you-go" plans designed to provide automatic inflation supplements to members of the TSF, PSSF and the Ryerson pension plan. The SAF was relieved from full funding requirements through a regulation under the 1987 PBA. The SABA act formally promised automatic inflation protection to "recipients" of pensions from plans "designated by the regulations". The designated plans were for teachers, public servants and Ryerson.

The act prescribed the method for calculating the adjustments in order to match 100 per cent of consumer price index (CPI) increases, with an annual cap of eight per cent and a carry-forward provision for the following year of any adjustment in excess of eight per cent in the previous year. Section 13 of the act also established a committee, among other matters, "to review from time to time (a) the rate of contribution to the Adjustment Fund by the employer and contributors; and (b) the account maintained under the Superannuation Adjustment Fund (SAF) account in relation to such pension plan." The act provided that no change in contribution rates should be made prior to January 1, 1981.

The SAF consists of three separate funds - one for teachers (the TSAF) - one for public servants (the PSSAF) - and one for Ryerson employees (the RSAF). As of December 31, 1986, these three funds held assets (based on book values) of $913 million, $380 million and $7 million respectively. The history of interest earned on the funds is contained in Appendix E.

The current contribution rates are one per cent of salary, paid on a matching basis by each of the employees and the employer. Although contribution rates have been adequate to pay for all the inflation adjustments to this point in time, projections indicate that these funds will soon be depleted - sooner for the public service than for the teachers. On the basis of such projections, it is likely that the contribution rates will soon have to be increased even if the SAF is kept on a "pay-as-you-go" basis.

The review committees, with representatives from employees and plan sponsors established pursuant to the 1975 act for each of the teachers' and public servants' indexing funds have met regularly to examine the cash flow and performance of the funds. These annual reviews have extended into the future the dates when these funds will be exhausted. Employee participation in the reviews has not been complete on the public servants' review committee because of reluctance of some organizations to participate within the legislative constraints. The review committees have directed the maturities of the investment of the funds. The review committees have never recommended an increase in contribution rates.

SECTION V

❐ Some Difficult Concepts

The financing of pension programs is complex. Thus it is not surprising that misunderstandings arise about some concepts. The most frequent such difficulties experienced in relation to the teachers' and public servants' pension programs concern: assets and surplus; interest earnings on new cash flows and average returns on the fund; and the unfunded liability of a modified pay-go pension program.

❐ Difficult Concept One

Repeatedly over the years, general statements have been made in many ways, such as the one that follows: the TSF has many billions of dollars of surplus which should be used to increase benefits and/or to reduce teachers' contributions. The confusion lies in understanding the relationships between financial assets or annual financial net cash flow to actuarial surplus/deficit.

❐ *Financial Assets*

- A pension program has contractual obligations to pay pensions to current pensioners ***and*** to pay future pensions on accrued service. As shown on a financial balance sheet, a snap shot of the total of these future liabilities is calculated at a point of time. In technical terms present value is determined by discounting future liabilities back to a valuation date. The fund balance for the TSF and PSSF uses a projected benefit method of valuation for both accrued and unaccrued service.

❐ *Surplus*

- To determine the financial status of a plan re: surplus/deficit, at a point in time, the pension fund will value its assets, such as stocks, bonds, mortgages, real property, etcetera. The assets can be valued, usually at market rates, as of the same date the liabilities are valued on.
- The total assets are then compared with the total liabilities. If the value of the assets exceeds the value of the liabilities, the fund is considered to have a surplus of the accumulations of assets over liabilities. If the value of assets is less than the value of liabilities, the fund is considered to have an unfunded liability.
- Assets are not of themselves surplus. They primarily secure the liabilites of past service pension obligations.
- If a surplus is available, then it alone is available for new commitments.

- ***Comparing Financial Balance Sheet Assets, Financial Net Cash Flow to Surplus***

- The difference between financial assets and surpluses is huge. For example, as of December 31, 1986, the TSFs fund assets were $10.54 billion, the liabilities were $10.08 billion, and the surplus was $461 million. The surplus is not the amount of financial assets, i.e., $10.54 billion.

- Similar calculations can be made for future benefits, contributions and investment earnings. On the basis of various assumptions about future work force, salaries, inflation, investment earnings etc., it is possible to forecast pension benefit obligations that will arise from future service. Similarly, future contributions and investment earnings forecasts can be made and discounted back to the present valuation date. If the present value of the expected pension benefits arising from future service is less than the present value of expected future contributions and investment earnings taken together, then the program related to future service is said to be in surplus. If the comparision is the other way around, it is said to be underfunded. Obviously, because of the hypothetical nature of pension programs, the state of fundedness dealing with future service is more uncertain than that related to past service. However, such valuations are essential in determining the adequacy of future contribution rates.

Difficult Concept Two

The next difficult concept concerns the differences that can arise between investment earnings on a pension fund's new cash flow and the average investment earnings on the fund as a whole, particularly when market rates change substantially over time. During the 1970s, for example, the average rate of investment earnings on the teachers' and public servants' pension funds was often substantially below the market rate on new issues of provincial bonds.

- The explanation is quite straightforward. The acts governing the teachers' and public servants' pension funds were given their general structures long ago, in much less inflationary circumstances. They required each year that the new cash flows coming available in the programs be committed to non-market provincial govenment instruments of maturity of 20 to 25 years. When interest rates were rising in the 1970s and early 1980s, each year's cash flow was issued a new batch of these long term investments, at the interest rate that reflected the market rate in that particular year. But the average interest rate on the whole fund was loaded down with long-term issues from the past which carried the lower coupon rates from the past. The pension funds were the victim of the huge increases in inflation rates and their inability to convert their portfolios into current higher yielding instruments.

- From the point of view of the pension funds, eventually "the road turned". When market interest rates receded in the 1980s from their extraordinary peaks, the funds contained a great deal of high coupon non-market debt insturments, with the result that the average investment earnings in the most recent years have been higher than the current marginal rate on new issues of provincial bonds. These events have given rise to the high streamed interest rates which have entered into the valuation of the teachers' and public servants' pension programs in recent years.

❒ Difficult Concept Three

A third difficult concept is an unfunded liability in a modified "pay-go" pension program, or part of a pension program. It is generally understood that with a modified "pay-go" approach, lower contribution rates today will give rise to higher contribution rates in the future. The concern over the soundness of the valuation of such a program arises from the fact that there is no definite obligation to increase the contribution rates in the future. Often there is only a vague and uncertain process for dealing with future contribution rates. The security of the program itself may thus be at risk because of the uncertainty of this process. The use of a funding standard for a modified "pay-go" program is partly to put some dimensions on the insecurity of the program.

Chapter 2

Proposals for Change Affecting the Teachers' and Public Servants' Pension Plans

Introduction

In 1987-1988, many proposals for change arose from a number of formal review procedures. Those include the Rowan report, the Coward report, the Friedland report, the pension benefits act, 1987, the proposed federal income tax amendments and the new accounting guidelines of the Canadian Institute of Chartered Accountants (CICA). These proposals, particularly from the Rowan, Coward, and Friedland reports, gave rise to our Consultations.

The Rowan report analyzes the Teachers' Superannuation Fund (TSF), Public Service Superannuation Fund (PSSF) and the Superannuation Adjustment Fund (SAF) as part of its study of public sector pensions. The Rowan report notes that certain practices were not in conformity with the formal arrangements, and emphasizes the need to clarify the pension deal, in particular concerning the sharing of risks and rewards arising from investment and actuarial experience.

The report recommends a shift in investment policy from non-marketable government debt to marketable assets such as stocks, bonds, mortgages and real property. This shift would entail higher investment returns but also greater risk and volatility. New formal arrangements would be required to deal with these consequences.

Both the Rowan and Coward reports urge that the SAFs be merged with their respective basic funds, and that the new merged funds be invested at arm's length from the government, preferably on a fully funded basis.

The Coward report determines the state of funding of the TSF, PSSF, and SAFs and calculates the contribution rates that would be necessary to provide the appropriate level of funding for pension benefits arising from future service. The report further determines the unfunded liabilities of these plans and the amortization payments required to discharge them.

The Friedland report examines alternative inflation protection formulae for both private and public sector plans. The province having agreed in principle to mandatory standards, the report recommends specific minimum standards for inflation protection, with incentives for employers to exceed these standards.

The Ontario Pension Benefits Act, 1987 (PBA) includes many new reform provisions. The transfer rights of plan members who terminate employment are particularly important, and the "50 per cent contribution rule" adds to the cost of these transfer rights. The TSF and PSSF have been granted exemptions from certain sections of the act and regulations, but implementation of the Rowan and Coward report recommendations could entail the repeal of these exemptions. Section 8 of the PBA regulations provides that inflation protection does not have to be funded, but if this provision were repealed, there would be a consequent impact on the pay-as-you-go formula of the SAFs.

Proposed amendments to the federal government's income tax provisions could have an impact on the teachers' and public servants' plans in at least three important respects. First, a new limit on employee contributions, of nine per cent of salary, could require an exemption for these plans if employee contributions were to be raised above this level. Also, the amendments include limits on the surpluses which pension plans may accumulate. Finally, the ceiling on the total pension permitted for each employee is scheduled to be increased above its recent level. This may entail additional costs, and perhaps, additional funding requirements.

The accounting profession, in both Canada and the United States, has recently instituted new guidelines for computing pension plan assets and liabilities for the purposes of private sector financial statements. These new guidelines also require that financial statements explicitly recognize pension plan assets and liabilities. Draft rules are currently being considered by the CICA for the public sector, and if they are adopted, the financial statements of the government of Ontario may be exposed to more scrutiny in regard to the unfunded liabilities of these pension plans.

SECTION II

❒ *Rowan Analysis and Proposals*

The Rowan Task Force was appointed with the following terms of reference:

> WHEREAS it is the desire of the government of the province of Ontario to ensure that the investment of public sector pension plans meets the needs and circumstances of today's financial environment, best serves the pension beneficiaries and advances the province's economic development;
>
> AND WHEREAS the government of Ontario believes it is in the public interest to establish a Task Force to study and report upon the investment of public sector pension funds;
>
> THEREFORE a Task Force be established pursuant to the public inquiries act:
>
> (a) to examine public sector pension funds in Ontario:
>
> i) to determine whether the current methods and approaches to the investment of such funds in Ontario most appropriately meet the needs of the present and future pension beneficiaries in today's economic and financial environment;
>
> ii) to determine whether economic development in Ontario could be increased through changes in the way public sector pension funds are invested;
>
> iii) to identify options available to the government;
>
> (b) to review the experience and practices of other jurisdictions with respect to the investment of public sector pension funds;
>
> (c) to recommend changes, as appropriate, with special emphasis on the major pension pools, including the Teachers' Superannuation Fund, the Public Service Superannuation Fund, the Superannuation Adjustment Fund, the Hospitals of Ontario Pension Fund (H.O.O.P.P.), the Workers' Compensation Board Pension Fund, Ontario Municipal Employees Retirement System(O.M.E.R.S.) and the Ontario Hydro Pension Fund;
>
> (d) to examine the way in which Canada Pension Plan funds are utilized and invested.

While the Rowan mandate was to consider the investment of public sector pension funds, the examination of this subject inevitably drew the Rowan Task Force into other questions concerning these plans. The report identifies various kinds of "pension deals" and focuses on the question, "(i) in whose interest are pension fund investments made?" The report examines 86 Ontario public sector pension plans and describes seven of these plans in considerable detail. Included in these seven are the TSF, the PSSF, and SAFs, for which the Rowan report presents the following recommendations:

❒ Teachers' Superannuation Fund (TSF)

- The Teachers' Superannuation Fund be established at arms length from the government and teachers, with its own board responsible for investment management and appointed by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.
- The TSF should be invested in market investments.

- The net cash flow of the TSF should be invested in market investments beginning in 1989: 20 per cent in the first year, 50 percent in the second year, and 100 per cent in the third and subsequent years.
- Non-market government debentures held by the TSF should be re-invested in market investments as they mature.
- Concurrent with a shift to market investments, the investment policy of the TSF should be changed to one which maximizes the return to the TSF at an appropriate level of risk.
- If the taxpayer remains liable for any deficit in the TSF, the government should seek to change the teachers' pension deal so that the taxpayer benefits from any investment risk surplus in the TSF.
- The government should seek to change the teachers' pension deal so that:
  - teachers can benefit from that part of an actuarial surplus in the TSF that results from their over-contributions, and
  - the taxpayer can benefit from the remainder of an actuarial surplus in the TSF.
- The government should initiate discussions with the Ontario Teachers' Federation to begin the process of merging the assets and liabilities of the TSAF with the TSF.
- The government should initiate discussions with teachers and their representatives to see if they wish to retain their current defined benefit related deal or have a new pension deal - for example, a shared risk/reward deal or a defined contribution deal.
- The government should establish a direct and clear link between salary negotiations and pension benefit discussions so that the total compensation paid to teachers can be revealed to teachers and taxpayers alike and appropriate trade-offs considered in a more explicit way.

❑ **Public Service Superannuation Fund (PSSF)**

- The PSSF be established at arm's length from the government and public servants, with its own board responsible for investment management and appointment by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.
- The PSSF should be invested in market investments.
- The net cash flow of the PSSF should be invested in market investments beginning in 1989: 20 per cent in the first year; 50 per cent in the second year; 100 per cent in the third and subsequent years.
- Non-market government debt held by the PSSF should be reinvested in market investments as it matures.
- Concurrent with a shift to market investments, the investment policy of the PSSF should be changed to one which maximizes the return to the PSSF at an appropriate level of risk.
- If the taxpayer remains liable for any deficit in the PSSF, the government should seek to change the public service pension deal so that the taxpayer benefits from any investment risk surplus in the PSSF.

- The government should seek to change the public servants' pension deal so that:
  - public servants can benefit from that part of an actuarial surplus in the TSF that results from their over-contributions, and
  - the taxpayer can benefit from the remainder of an actuarial surplus in the TSF.
- The government should initiate discussions with public servants and their representatives to begin the process of merging the assets and liabilities of the PSSAF with the PSSF.
- The government should establish a direct and clear link between salary decisions and pension benefit decisions so that the total compensation paid to public servants can be revealed to public servants and taxpayers alike, and appropriate trade-offs considered in a more explicit way.
- The government should initiate discussions with public servants and their representatives to see if they wish to retain their current deal or have a new pension deal - for example, a shared risk/reward or a defined contribution deal.

❐ **Superannuation Adjustment Fund (SAF)**

- The Management Board of Cabinet should initiate discussions with the three SAF review committees with the object of developing a funding policy for the TSAF, the PSSAF and the RSAF which fairly apportions the cost of inflation indexation between current and future plan members and taxpayers.
- The appropriate assets of the SAF should be merged with the TSF and PSSF once these funds have been established as arm's-length investment agencies....and a more realistic inflation indexation funding policy is in place. Similarly, the RSAF assets should be merged with the Ryerson fund once a more realistic inflation indexation funding policy is in place.
- Subject to the first recommendation, the net cash flow of the three SAF funds should be invested in market investments as part of the TSF, PSSF and Ryerson fund, beginning in 1989: 20 per cent in the first year, 50 per cent in the second year and 100 per cent in the third and subsequent years.
- Subject to the first recommendation, non-market government debt held by the SAF should be reinvested in market investments as it matures, through the TSF, PSSF and the Ryerson fund.
- Concurrent with a shift to market investments and with a merger of the three SAF funds with the TSF, PSSF and Ryerson fund respectively, the investment policies of the merged funds should maximize the return to the base funds at appropriate levels of risk.

While some people might prefer to continue the TSF, PSSF, and SAFs as they currently exist, the Rowan report recommendations favour significant changes in the nature of the pension deal, the sharing of risks and rewards, the market investment of the pension funds, and increased participation of members in the governance of these plans. The Rowan report recommendations on structure and governance are limited by its terms of reference. The terms are derived from investment policy. Thus the Rowan report recommendations on governance primarily concern investments. Because our terms of reference are comprehensive with respect to teachers' and public servants' pension programs, our concern with structure and governance includes all aspects of pension policy.

At the core of the Rowan report recommendations concerning the TSF, PSSF,and SAF is the belief that "public sector funds should be governed by the same rules as private sector funds" (Rowan, p. 1). The structure and processes of each of these public sector plans would resemble those of the large private sector plans. Plan administrators and trustees should be appointed to make investment decisions at arm's length from the government.

The Rowan report notes that some people could say that the non-market government debt held by the TSF, PSSF, and SAFs is a form of "social investing" or "concessionary investing" that assists the government in achieving public objectives. However, the report recommends that the plan trustees not be restricted to non-market government debt. Rather, they should decide upon their investment policy in light of the pension deal and the risk tolerances of those whose interests are affected. The TSF,PSSF, and SAFs should be regulated by the 1987 PBA, just as private sector plans are. This act places responsibility on the plan administrator to act in accordance with "a prudent person approach." [1]

With this new administrative structure and with the prudent person directive, the TSF, PSSF, and SAF should be invested in a portfolio quite different from the non-marketable government debt acquired prior to this reform. Of the 86 public sector plans, only the TSF, PSSF, and SAF currently invest in non-market government debt. One other fund, the Ontario Municipal Employees Retirement System (OMERS) invested in non-market government debt prior to 1975, but since then it has shifted to a diversified portfolio of market investments; and only a small percentage of its assets are still invested in non-market government debt. With investments in marketable assets, the TSF, PSSF, and SAF would likely experience a higher rate of return on average than they have in the past. The funds could also experience a greater variation in that rate of return over time, with a risk that the return might be quite low, or even possibly negative in some years.

With this new approach to the investment of funds, it would be necessary to clarify how the higher return and greater risk accompanying a market-oriented portfolio would be shared between the employer and the employees. It would be necessary to clarify how any unexpectedly high returns and surpluses would be shared, and how any unexpectedly low returns and deficits would be covered. In regard to the investment of the funds, the question "In whose interest?" would require a precise answer.

In view of the nature and significance of the pension deal, and the separation of its administration from government control, the Rowan report recommends that pensions should be considered as "part of total compensation and should not be dealt with in isolation" (Rowan, p. 2). Employees should have the right to participate in pension fund decision-making. There should be "a more market-orientated, less paternalistic, approach to public sector pension funds" (Rowan, p. 2).

For the Rowan Task Force, the SAFs presents a special problem. "Without a clearly stated and reasonably predictable funding policy, development of an appropriate investment policy for the SAF is almost impossible" (Rowan,p. 181). The Rowan report expresses a strong preference for the full funding of inflation protection. "Suffice it to say, we do not believe it is fair for current plan members and taxpayers to push the cost of inflation indexation off onto future generations of plan members and taxpayers" (Rowan, p. 183). Whether or not inflation indexation is to be funded fully, the contribution rates should be increased, and the fund should be invested in wealth-producing

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[1] The administrator is required to exercise the care, diligence, and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person. The administrators also required to use in the administration of the pension plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of his or her profession, business or calling, ought to possess (Rowan, p. 90).

assets. From the Rowan report perspective, this recommended approach should include the merger of each SAF with its respective basic TSF and PSSF, once these funds have been established as arm's length investment agencies.

SECTION III

❒ *Coward Analysis and Proposals*

The Coward report analysis focuses on alternative methods for providing funding for the TSF and PSSF and for determining appropriate contribution rates for these plans; and on the measurement and discharge of the unfunded liabilities of the associated indexation programs. The Coward report does not discuss the Ryerson Superannuation Plan separately, but states that "the recommendations made for the Public Service and Teachers' Plans apply to the Ryerson plan in all essentials" (Coward, "Introduction", p. 1). The analysis was based on four principles:

- Public sector employees should not be financially advantaged, or disadvantaged relative to private sector employees by their participation in pension plans sponsored by the government of Ontario;
- Public sector pension plans should be valued in a manner that identifies their full cost and relates it to the periods of service during which the pensions were earned;
- The cost of financing pension benefits should be apportioned fairly among the current and future generations of contributors and taxpayers;
- The full cost of public sector plans should be disclosed publicly for: the information of plan members who contribute to and benefit from the plans; the government which is responsible for establishing public sector compensation; and the taxpayer who provides the government's contributions to the plans and underwrites the promised benefits.

These four principles underlie the Coward report recommendations. In particular, they explain the report's rejection of the pay-as-you-go approach that has directed the SAF since it was established in 1975. The Coward report believes that those pension benefits should be paid for as they arise, rather than being passed, in whole or in part, to future generations, and that public sector pensions should be on the same basis as private sector pensions. In the past, the liabilities of the SAFs have been unrecognized. It is vital, in the Coward report's view, that there should be a full disclosure of costs and liabilities. A very important objection to pay-as-you-go funding is that true costs are not disclosed. Pay-as-you-go masks the fundamental relationship between the cost of the basic plans and SABA. Therefore, SABA liabilities are unrecognized. An additional concern relates to the future security of the fund. Unlike a private employer, the risk of bankruptcy for the Ontario government is negligible, and so some people might not feel a need to fund the SAFs fully to ensure the future security of the fund. Yet, even with the government's backing of the SAFs, the Coward report expresses a concern. In view of the matching contribution precedent, the question arises whether a future generation of employees and taxpayers will pay the much higher contribution rate that will be required if the SAFs remain on a pay-as-you-go basis.

- If the contributions to the SAFs are not increased until the funds are exhausted the matched contribution rate would then jump from one per cent of salary to about 2.6 per cent for public servants and to about 4.4 per cent for teachers. This would not be the end of the story, for the projections indicate that in the year 2019 contributions would be required at the rate of about 4.3 per cent for public servants and 6.9 per cent for teachers. Hence, very large contribution increases would be required at the time when the rate of anticipated inflation might be much less than it is today. If this were so, the government might find it impossible to get the employees, as a group, to pay half the cost of the indexation.

- Fortunately these difficulties and the unfair transfers of cost to future generations can be avoided. The problems of intergenerational transfers will largely disappear if, as we recommend, the basic PSSF and TSF are combined with the respective SAFs and properly funded (Coward, Part II, pp. 6-7).

The Coward report believes that the TSF and the PSSF should be merged with their respective SAFs, and the entire set of pension benefits should be fully pre-funded. This would reveal substantial unfunded liabilities for the new combined plans. Since a precise estimate of the unfunded liabilities depends upon a number of assumptions, the Coward report presents a range of estimates. For example, with a reasonable set of assumptions, the unfunded liability of the PSSAF for service to date would have been $1.6 billion as of December 31, 1985, and that of the TSAF for service to date would have been $3.5 billion. The unfunded liabilities for past service plus those which would arise from future service would be substantially higher than these estimates if the contribution rates were to be kept at the present level. The Coward report recommends that the past service unfunded liabilities, calculated as of the effective date of the reforms, be paid entirely by the government over a chosen period of between 15 and 25 years.

The Coward report emphasizes that the current separation of the basic funds from the SAFs can automatically result in one fund being in deficit while the other is in surplus. With a zero inflation rate and the existing benefits and contribution rate, for example, the basic plans will likely be in deficit while the SAFs will likely have a somewhat smaller surplus, the combined whole program being in deficit. With a high inflation rate and the current contribution and benefit structure, the basic plans will likely show a small surplus while the SAFs will likely have a larger deficit. In view of this, the separation of the basic plans from the SAFs can introduce a set of funding problems and controversies over contribution rates that can be avoided through the merger of the plans and the introduction of a single contribution rate.

The Coward report approach would require a substantial increase in the regular matching contribution rates to maintain, for future benefits, fully indexed pensions at current benefit levels, with some improvements to meet PBA minimum requirements. The contribution rates for employees should, in the Coward report's opinion, be one-half of the full and true cost for a new entrant, using the "entry age normal valuation method." This would result in current contribution rates somewhere in the range of nine per cent to 11 per cent of salary for each of the employees and the employers for a new merged plan for each of the teachers' and public servants. These rates presuppose a real rate of return based upon what the report believes could be attained through market investments, and include the additional costs imposed by the pension reforms in the 1987, PBA. The precise figure would differ between the TSF and the PSSF and would depend upon the assumptions chosen in regard to future inflation rates, salary increases, rates of return and other considerations. Still, even if the contribution rates were based upon the higher rates of return that could be attained through market investments with a modest level of investment risk, they would exceed the current contribution rates by a considerable amount.

In calculating appropriate contribution rates, it is necessary to consider the costs of new regulatory requirements imposed by the 1987, PBA. The act provides employees with new rights in regard to pension benefits, and these are discussed later.

For many calculations, the Coward report presents estimates based on pre-reform costs as well as estimates based on post-reform costs. The Coward report notes that these pension reforms could create an unforeseen drain on the existing funds, resulting in the depletion of the SAFs at an earlier date than currently anticipated. Of particular concern are the new rights of employees, when they terminate employment, to withdraw the commuted value of their pension rights, fully indexed, from the plan and to transfer this amount to an RRSP, to another employer's plan, or to a life insurance company to purchase an annuity. These transfer rights include the employee's right to receive a refund for any contributions in excess of 50 per cent of the commuted value (present discounted value) of the pension. In this regard, the Coward report suggests that "the government will have to provide something extra for employees who benefit from the 50 per cent cost-sharing rule..." (Coward, Summary, p. 9).

An additional change that will impact total contributions arises from the increasing contribution rates for the CPP. Contribution rates in the Coward report were based upon CPP contributions by each of the employer and employee of 1.8 per cent of salary up to the CPP maximum yearly pensionable earnings. However, these rates are scheduled to increase regularly until 2011 when they will have reached 3.8 per cent of earnings for each of the employer and employees.

The following table from the Coward report (Part VII - p. 6) indicates the probable range of required employee contribution rates for a new combined plan for each of the teachers and the public service. Contribution rates have been calculated both on the basis of pension costs prior to PBA, 1987 and also on the basis of the higher pension costs imposed by the reforms required by PBA, 1987. The Coward report observes that the historical division of the regular contribution costs between the employer and employee on a matching basis has been generally accepted, and sees considerable merit in continuing the past 50/50 sharing. Consequently, the contribution rates in Table 10 below have been calculated on this 50/50 basis. It should also be noted that these contribution rates have been calculated on the basis that the unfunded liabilities, as of the effective date of the reforms, would be paid entirely by the government. In spite of the substantial increase in contribution rates indicated in Table 10, and the substantial unfunded liabilities to be paid for by the government, the Coward report does not recommend any reduction in pension benefits. It suggests that the current benefit formula be retained and that 100 per cent inflation protection - subject to the eight per cent cap on each annual adjustment - be continued.

❒ *Members' Contributions - Entry Age Normal Cost (Table 10, Coward report)*

Assumptions			PSSF		TSF	
Interest	Salaries	Inflation	Before Reform	After Reform	Before Reform	After Reform
7 %	5%	4.5%	8.59%	9.18%	9.80%	10.20%
7 %	6%	4.5%	9.47%	10.05%	11.01%	11.42%
7.5%	6%	4.5%	8.55%	9.07%	9.86%	10.24%
8 %	6%	4.5%	7.76%	8.25%	8.85%	9.21%

These members' contribution rates should be reduced by 1.8 per cent of earnings between the YBE and the YMPE under the Canada Pension Plan.

The Coward report devotes a considerable portion to the choice of alternative actuarial assumptions, and the implications of these alternatives for the level of contribution rates. Conclusions in regard to the actuarial assumptions are contained in the following recommendations:

> **Recommendation (13)** The PSSF and TSF should be valued by the same actuarial method and using the same actuarial assumptions except where probable differences in demographic or economic conditions can be demonstrated.
>
> **Recommendation (18)** In determining members' contribution rates, the economic assumptions in the pre-retirement period should be:
>
> Real investment return - three per cent per annum
>
> Real salary increases - 1.5 per cent per annum plus promotion and seniority
>
> Inflation rate - 4.5 per cent per annum

Recommendation (19) In determining members' contribution rates, the economic assumptions in the post-retirement period should depend on the investment policy and philosophy of the government.

(a) If the government's policy is to minimize its risks by investing pensioners' reserves in short-term fixed-interest securities or to base the contribution rates on the economic value of fully-indexed pensions, a real interest rate of two per cent per annum should be used.

(b) If the government is prepared to absorb the risks of variability in market investments, a real interest rate of three per cent per annum should be used.

Recommendation (25) Streamed interest rate and salary rate assumptions should be used for a few years after the valuation date to take account of known facts. The ultimate real rate of return should be three per cent (or three per cent before retirement and two per cent after retirement if the government is risk-averse); and the ultimate real salary increases should be 1.5 per cent plus seniority and promotion (Coward, Summary, pp. 8-9).

The Coward report recommendations are based upon the continuation of the teachers' and public servants' plans as defined benefit plans sponsored by the government and guaranteed by the government. The report is greatly concerned about the financing of these plans being put on a sound long-term basis. It is the report's view that a reasonable contribution rate should be determined for the participants aimed at sharing the costs equally between participant and government. However, it is recommended that if the practice be continued that deficiencies in the fund be made up by government, but that government be equally entitled to surpluses. The report recognizes that determination of the costs of the program must carry the confidence of the participants, as well as government.

SECTION IV

❒ *Friedland Analysis and Proposals*

The Friedland report, starting from the province's acceptance in principle of mandatory indexation of pensions, presents recommendations concerning specific government requirements for inflation protection in both private and public sector pension plans. Underlying these recommendations is the belief that government regulations should be expressed as legally mandated minimum standards. In the Friedland report, an important finding is that the costs of inflation protection differ substantially among plans, and that for each plan, these costs vary substantially over time. Full inflation protection, incorporating 100 per cent of the CPI increases, would impose very high costs on many plans. Full retroactivity would impose additional high costs on many plans. By focussing its recommendations on legally mandated minimum standards, the Task Force believes that the negative impacts on Ontario's competitive position - and hence on employment and profitability - should be constrained to an acceptable level.

For some employers, full inflation protection with full retroactivity may be acceptable. In the opinion of the Task Force, such employers should be encouraged to exceed the legally mandated minimum standards. In particular, the provision of retroactivity is highly desirable from the perspective of fairness, equity, and compassion - and so that area deserves special attention as the focus for incentives to exceed the legally mandated minimum standards.

It is from this perspective of constraints on costs and constraints on the risk of variability in costs and funding that the Task Force recommends only partial inflation protection, caps on the annual adjustments, and no obligatory retroactivity.

The Task Force believes that the availability of indexed bonds would enable pension funds to reduce the impact of unforeseen changes in inflation and inflationary expectations. This would be particularly helpful with defined benefit plans, improving the accuracy of cost and benefit projections and thereby diminishing the probability of unforeseen surpluses or deficits. Consequently, the Task Force recommends that the Ontario government issue indexed bonds.

The report notes that "(i) in submissions to the Task Force, and in our public hearings, no issue aroused more heated discussion than the question of surplus ownership" (p. 253). Within the legal profession, there is no consensus on this question. Some see pension funds as established on the basis of a specific contract. Their only purpose is to provide for the defined benefit in that context. Hence, any surplus belongs to the employer. This contract perspective sees employees as entitled only to the contractually promised benefit. On the other hand, some see pension funds as a trust established for the benefit of the employee. These are funds held in trust for the employee, and so the employer may not claim ownership of the fund or any surplus that has arisen in it. Finally, the issue of contribution holidays deserves comment. One might consider these to be the equivalent of surplus withdrawal, but the report recommends that they be dealt with differently. While surplus withdrawal should depend upon provision of retroactive inflation protection, contribution holidays should not be constrained.

In a separate statement, Mr. Pilkey, as a member of the Friedland Task Force, argues for obligatory retroactivity and a prohibition of both surplus withdrawals and contribution holidays.

SECTION V

❒ *The Ontario Pension Benefits Act, 1987*

The PBA and its regulations include many new reform provisions. Some of these, like the joint and survivor requirement, do not necessarily involve an increase in costs; others involve additional costs that can be calculated with actuarial methodology that is generally accepted.

For the teachers' and public servants' pension programs, the most important and most costly of the reforms are the increased benefits in vesting and portability. There are some provisions of the new act where decisions will have to be based upon interpretation and judgment. With a few exceptions, the act and its regulations are not retroactive. For the teachers and public servants, retroactivity may be implemented in regard to a number of provisions, but the PBA provides few requirements.

Section 40 of the act requires that each employee's contributions plus interest shall not exceed 50 per cent of the commuted value of that employee's pension. Any amount by which the employee's contributions plus interest do exceed 50 per cent of the commuted value of the employee's pension shall be refunded to that employee. The relevant calculations shall be performed at the time of termination of membership or employment. Consequently, every member will potentially come under the 50 per cent rule of subsection 40(3) at some point in their career. This pension reform may increase the entitlement of some public sector employees, and so may be an added drain on both the basic plans and the SAFs.

The act and the regulations prescribe the methods that may be used to calculate interest to be applied to employee contributions at the time of termination of membership or employment. In the past, many plans have used arbitrary below-market rates in such calculations, to the disadvantages of those withdrawing from a plan. The new regulations will require the use of rates of interest based on the market or plan performance. These changes will have little effect on the teachers' and public servants' programs.

At the present time, the TSF and PSSF have been granted exemptions from certain sections of the act and regulations. Implementation of the Rowan and Coward report recommendations could entail the repeal of these exemptions. The exemptions include:

- Subsection 23(1) requires that the plan administrator exercise the care, diligence, and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.
- Section 63 requires that the selection of investments be in accordance with the criteria set out in the Act and prescribed by the regulations.
- Section 8 of the regulations provides that the estimated future costs of escalated adjustments may be excluded from funding requirements.
- A major reason for inserting the provision in section 8 of the PBA regulations was to allow the Ontario government to permit modified pay-go funding of its promised inflation protection. Two points need comment.

  First, in recent years accountants and securities analysts have become increasingly concerned about unfunded pension promises. New CICA guidelines and new FASB rules require that financial statements explicitly report the liability connected with escalated adjustments. There are also new CICA guidelines in exposure draft form for public sector pension accountability. The government of Ontario may increasingly be subjected to scrutiny from securities analysts in this regard.

  Second, section 8 of the PBA regulations could conceivably be repealed. This would require the funding of escalated adjustments in the teachers' and public servants' pension plans.

SECTION VI

❒ *Income Tax Provisions*

On March 28, 1988, the federal government's Minister of Finance issued "Draft Amendments to the Income Tax Act and Income Tax Regulations Relating to Saving for Retirement." These draft amendments deal with many aspects of pension plans, several of which may be of particular relevance for the teachers and public service. These changes include application of a new limit on the permissible employee contributions to a pension plan. If a plan fails to comply with this limitation on contributions, then the plan will not be registered for income tax purposes, and employee contributions will not be tax deductible. This contribution limit is expressed as the lesser of nine per cent of the member's remuneration for the year, or the aggregate of $600 and 70 per cent of the member's pension credit for the year. The binding provision for the TSF and PSSF would be nine per cent of the member's remuneration for the year. Some leeway may arise from the integration of CPP contributions. The proposed limitations are found in Paragraph 147.1(3)(a) of the draft amendments.

The amendments also present permissible contribution limits when a plan is in a surplus position. This situation had previously been dealt with in an "Information Circular". Current service contributions may be made while a plan has a moderate amount of surplus. However, contributions cannot be made if the surplus exceeds either 20 per cent of actuarial liabilities or twice the combined employer and employee current service cost. For plans in a surplus position, these restrictions in Paragraph 147.5(2)(e) could become relevant in the future in calculating permissible contributions.

A third proposed change concerns the maximum annual benefit permissible in a defined benefit plan such as that of the TSF or PSSF. For some time, Revenue Canada has imposed a ceiling on permissible pension levels. The current maximum annual pension is about $60,000 for pensionable service of 35 years. Teachers' and public servants' plans conform with this requirement. However, it is proposed that this ceiling will soon be raised. For some employees, this would increase the promised level of pension benefits, and so consideration may have to be given to the implications of this change for the cost and funding of the TSF and PSSF. Details of the proposed changes are found in Subsection 147(4) of the draft amendments.

SECTION VII

❒ *Accounting Guidelines*

Prior to December, 1986, Canadian accountants and auditors prepared financial statements without particular concern for the assets and liabilities of pension plans. They generally accepted the certified calculations made by each plan's actuary. In recent years, the size of pension commitments has increased dramatically, as have the pension funds created to meet these commitments. Consequently, chartered accountants and securities analysts, as well as prospective purchasers of bonds and equities, have become more concerned about the possible impact of pension funds on the future financial viability of the employer. The credit rating of the employer can be affected by the accountants' analysis of pension plan assets and liabilities. This new concern exists in regard to both corporate and public sector employers.

The Canadian Institute of Chartered Accountants (CICA) has issued a revised Handbook, in which Section 3460 discusses the new guidelines for Canadian accountants in regard to private sector pension plans. Draft rules for the public sector are being considered by the CICA and, if adopted, may have important applications for public sector pension plans. In the United States, the Financial Accounting Standards Board's (FASB) SFAS No. 87 presents guidelines that are also aimed at clarification of an employer's financial obligations connected with pension plans. For employers like the Ontario government who may sell securities in the United States, compliance with the FASB rules may be necessary, as well as compliance with the CICA requirements.

CHAPTER 3

What Was Said

Introduction

The Consultations' terms of reference required us to conduct discussions and to provide a forum for comment on the conclusions and recommendations of the Coward, Rowan and Friedland reports as they relate to teachers' and public servants' pensions. This chapter summarizes the submissions received.

We advertised widely and contacted a broad range of interested groups and individuals to ask for submissions. Those contacted include public servants, teachers, pensioners, employee representatives, business, financial, academic, actuarial and benefits consulting communities, and the general public. Copies of our terms of reference were provided as guidelines to organizations preparing submissions.

In further keeping with our mandate, we initiated visits and hosted a seminar for different groups to discuss various issues. We received 91 briefs and the visits we made and participants in our seminar are included as Appendices B, C, D.

We would especially like to comment on the value of the May 19 - 20 seminar as an opportunity to air differing views and test various issues of fact and opinion "without prejudice". The seminar was well represented by a diverse group, composed of 17 employee representatives, 15 government officials, 15 academic, actuarial, finance, business professionals and other interested groups.

This chapter is divided into five sections:

- I **Teachers' views on teacher pensions**
- II **Public servants' views on public service pensions**
- III **Administrators' views**
- IV **Central labour bodies**
- V **Views of other interested organizations and individuals submitting briefs**

SECTION I

❐ *Teachers' Views*

This section reviews comments received from teachers and their representatives. Submissions were received from the Ontario Teachers' Federation (OTF), the Ontario Secondary School Teachers' Federation (OSSTF), eight local teacher groups, and 28 teachers and retired teachers. A number of representations to ministers and other members of the legislature were copied to the Consultations.

In general the individual submissions received from active and retired teachers expressed views on:

- The improvement of benefits (higher accrual rates, earlier retirement, recalculation of benefits on "best five" basis for all teachers, purchase of past service, survivor benefits after retirement).
- The government not investing teacher pension fund monies to the best interest of the pension fund.

- The retention of the present inflation protection level.
- Ensuring that pension funds are invested in the market with teachers represented on the investment committee, including retireds.
- Not increasing contribution rates.
- Decreasing contribution rates.
- Some teachers feel that investments should be kept at arm's length from both the government and teachers. A minority feel that investments should not be invested in the market but that a better rate of interest should be credited to a fund.

There is widespread scepticism among individual teachers about the financial status of the Teachers' Superannuation Adjustment Fund (TSAF). Some of the submissions point to the fact that several dates have been advanced about critical financial points in time for the TSAF and further indicate that financial forecasts are merely conjecture. Others compare the Ontario teachers' pension program with comparable public sector pension plans and ask why these plans can provide equivalent, if not better benefits, for less cost.

The individual submissions generally indicate that a rate increase is unnecessary. In general, these submissions are opposed to a merger of the Teachers' Superannuation Fund (TSF) and the TSAF. Some suggest that the basic plan could transfer some of its actuarial surplus to the TSAF if necessary.

While, due to its own particular considerations, the OTF formal submission was limited in scope, the federation officers were very helpful participants in informal discussions and in the Consultations seminar.

The OSSTF also met with us and gave us their points of view, which concur mainly with the OTF's submission.

We had discussions with staff of the Ministry of Education regarding past experience and the nature of the current issues.

The comments of other parties interested in the Consultations are outlined in *Section IV.*

The OTF's main points were as follows:

- Teachers and government must jointly enter negotiations to develop a mutually satisfactory plan.
- Any ratified plan must include equal teacher representation.
- Restrictive investment placements have resulted in foregone earnings and inflated pension costs.
- The investment of teachers pension funds must be diversified.
- The government must remain plan sponsor and plan guarantor.
- Teacher pensions, including surpluses, belong to teachers/beneficiaries.
- The needs of teachers militate against merging with other public sector pension plans.

Comments fall into the following categories:

- Future pension benefit program
- Determinants of long term costs
- Paying for pension costs
- Investment policy
- Governance/structure

Future Pension Benefit Program

Basic Benefits and Design

Teachers place a high priority on their pension plan and are very conscious that teachers make significant contributions to their retirement income savings arrangements. The OTF said that pension plan provisions have met teachers' needs well.

Determinants of Long-Term Costs

Risk/Reward: Actuarial Assumptions/Financial Perspectives

Teachers emphasize that plan valuation assumptions should be both realistic and open and they should reflect the potential for increased investment earnings.

Real Rates of Investment Return

Teachers feel that future long-term real rates of investment return from a diversified investment portfolio should permit significant improvements of benefits or decreases in contribution rates for teacher pensions, compared with what could be achieved under the existing investment policy.

If the TSF and TSAF were to remain separate funds and did not assume undue investment risk, the OTF estimates that the predicted 200 basis points increase over the past long run average would permit a 30 to 40 per cent benefit increase or premium decrease on the TSF/TSAF.

Under a diversified investment program, the OSSTF expects an improved real rate of investment return on both the TSF and the TSAF investment funds.

Paying for Pension Costs

Funding Policy

The OTF monitored the TSAF carefully and is aware of available cash flow projections. Over the past few years, the OTF has continued to indicate to the government its willingness to develop co-operatively a plan to improve the security of the escalation benefit. It wants to develop this plan through negotiation, with ratification by both the government and the OTF.

The OSSTF 's position is that while, in principle, all pension funds should be fully funded, the TSAF should not be fully funded until it matures. It recommends letting a reasonable length of time elapse before measuring the results of diversified investments. As noted earlier, the OSSTF anticipates a large increase in the future real rate of investment return.

Financing Past Service Liabilities with Respect to Cost Sharing Distribution and Amortization Arrangements

The OTF believes that the Treasurer's guarantee of pension rights for accrued service and of pensions already in pay are important steps towards sustaining benefit security.

❐ Setting Contribution Rates

The OTF indicates that teacher contributions are already significant and that employee contribution levels must reflect increased earnings potential from diversified investments. The position is that all assets, including surpluses, belong to the beneficiaries for whom the pension plan is in trust. The OSSTF opposes an increase in teacher or taxpayer contributions until the TSAF matures.

❐ Investment Policy

❐ Market vs Non-Market Investments

Teachers strongly support market investment and diversification of both the TSF and TSAF. The OTF puts the following conditions on their support:

- The government must remain the plan sponsor and plan guarantor.
- There must be equal representation on any administration board and investment policy committee.
- Investment policies must be limited to the security of capital/benefits and to ensuring the best possible returns within the bounds of prudent financial management.

❐ Capital Market Impacts

Teachers see the move to investment diversification as a phased-in process. Having regard for the magnitude of the assets, the OTF recommends that new cash flow be diversified gradually, over a three to five year period, and that existing debentures be moved into a market portfolio as they mature.

❐ Investment Management

Teachers recommend that investment management structures and objectives should be established and operating well in advance of the date on which diversification would commence.

❐ Governance/Structure

❐ Benefits, Fund Investment, Plan Administration Elements and Fiduciary Concerns

The OTF makes a number of recommendations under investment diversification. As part of its position, it has firm points of view on the government remaining plan sponsor and plan guarantor; benefit design and plan refinement being agreed to jointly, and main plan provisions remaining in legislation. It wants the TSC, or its successor, to have responsibility for pension administration, benefit adjudication, and pension investments.

❐ Benefits Policy

The OTF emphasizes that benefit design and plan refinement are now determined jointly with the government and they want to ensure the arrangement continues. The OTF points out that teachers interests need to be safeguarded as much as employers' interests.

Representations by retired teachers were made to have the base for calculating teachers' pensions to be on the same formula (best five years average salary) for everyone, in particular those who retired after 1981. The request is not to have a retroactive adjustment for pension payments already made, but rather for recalculation for future pension payments. The issue is seen to be a classic case of fairness among various interests in pension plans, particularly when benefits are changed.

- **Fund Investment**

  The OTF would support the creation of a committee of government and OTF representatives to design a comprehensive plan for the diversification of TSF investments. The ratified plan must meet all conditions noted above, with the further stipulation that investment strategies must be devoted to the best returns possible under responsible financial management. Further, teacher investments must not be invested in concert with other public sector pension plans.

  Teachers propose an investment policy committee be formed under the auspices of the TSC, or its successor. This committee would work within the objectives and guidelines established by the TSC, or its successor. The composition of this committee would include senior investment community representatives, the TSC (or its successor), the government and the OTF. This committee would establish investment policy, approve investment strategy and ongoing expertise, monitor performance, select and review external investment managers.

- **Plan Administration**

  Plan administration should continue to be held by the TSC, or its successor, with those additional responsibilities indicated above.

- **Fiduciary Concerns**

  The OTF stipulates that the government must remain the plan sponsor and the plan guarantor.

SECTION II

Public Servants' Views

This section reviews the comments we received from public servants and their representatives who are participants in the PSSF/PSSAF. Submissions were received from the Ontario Public Service Employees' Union (OPSEU), Ontario Provincial Police Association (OPPA), Canadian Union of Public Employees (CUPE), Ontario Liquor Board Employees' Union (OLBEU), five local employee representative groups, and 16 public servants and retired public servants. The OPSEU and CUPE submissions were developed in co-operation with each other and the OLBEU. A number of representations to ministers and other members of the legislature were copied to the Consultations.

In general the individual submissions from active and retired public servants expressed the following views.

- Support of greater investment returns through diversified, market investments.
- Support of reducing current contribution rates or keeping at their present level.
- Support of improving pension benefits, for example, survivor benefits, portability, higher accrual rates, earlier retirement, Canada Pension Plan (CPP) contributions stacked not integrated.
- Support of not passing the PSSAF funding deficiency onto employees.
- Support of merging the Public Service Superannuation Fund (PSSF) and the Public Service Superannuation Adjustment Fund (PSSAF) only if contribution rates would be reduced as a result of merger.

- Support of the creation of an investment policy committee with equal government and employee representation. Some believe that the investment policy committee should be at arm's length from both the government and employees.
- Support of giving employees an option to invest in RRSP's instead of contributing to the PSSF/PSSAF.

There is a widespread view among these submissions from individual active and retired public servants that the current funding deficiency is directly related to the government's unilateral policy of investing in non-marketable Ontario government debt. Past and current investment returns are perceived as poor and the employer is believed to have invested the pension funds unwisely. Generally these submissions suggest that the government is responsible for any accumulated funding deficiency.

One local employee group recommended: that the 50/50 cost sharing relationship continue, with any unfunded liabilities being the responsibility of the government; that the government manage the pension funds better, at higher rates of returns, and that they continue to invest the funds in the public sector, with more innovation in the investment selection and timing of maturities; that the PSSF and PSSAF not be merged; that greater emphasis be put on employee communication and involvement.

OPSEU, OPPA, CUPE and OLBEU met with us and were very helpful participants in both informal discussions and in the Consultations seminar. Their submissions were carefully and thoughtfully crafted and we appreciate the generosity of sharing points of view and positions.

We had discussions with the staff of the Human Resources Secretariat regarding past experience and the nature of the current issues.

The comments of other parties interested in the Consultations are outlined in *Section IV*.

OPSEU, CUPE, OLBEU principal areas of concern were:

- Pension negotiability;
- Inflation protection;
- Improved investment returns;
- Cost sharing and contribution rates;
- Improved pensions and early retirement provisions for union members in high stress occupations, particularly those in the lower segments of wage and salary scales;
- Equal employee and employer representation in ongoing fund/plan management;
- Surplus/deficit policies. These unions want full negotiability in order to ensure that pension plan members have the right to decide pension issues in the same way all other compensation matters are decided.

The OPPA principal recommendations were:

- Continue the present level of inflation protection.
- Improve investment returns.
- Amalgamate the PSSF and PSSAF.
- Increase contribution rates equal to one per cent of earnings each side together with a continuation of modified "pay go" financing.

- If full funding is necessary, agree to the increase noted with an additional 1/10th of one per cent until 1999 or full funding achieved.
- Monitor and review the state of funding.
- To have the government retain overall fund control but the OPPA to make administration suggestions.

Comments from OPSEU, OPPA, CUPE and OLBEU can be placed into the following categories:

- Future pension benefit program
- Determinants of long term costs
- Paying for pension costs
- Investment policy
- Governance/structure

Future Pension Benefit Program

Basic Benefits and Design

OPSEU, CUPE and OLBEU believe that this is an appropriate time to reassess the public service plan in all important aspects. They point out that their plan members may not enjoy a significant return on their pension contributions because of its more mobile work force and the effects of high stress occupations on workers.

OPSEU, CUPE and OLBEU point to portable pensions with indexed benefits, earlier retirement provisions, and revised CPP integration to eliminate pension inequities for lower wage employees.

Level of Indexation

OPSEU, CUPE and OLBEU strongly support having all pensions fully protected against inflation. They believe that full indexing of benefits is realistic for all responsibly managed funds. OPSEU makes the point that it was "blackmailed" into participating in SABA. They say that "the government threatened to discontinue ad hoc inflation adjustments if OPSEU did not accept the arrangement to create the Superannuation Adjustment Benefits Act (SABA)". The OPPA wants to retain its present level of indexing.

Total Compensation

OPSEU, CUPE and OLBEU believe that a satisfactory resolution to public service pension issues can only be achieved through negotiations between the employer and union. They would add that within a negotiation setting, a practical means to resolving negotiation disputes must be in place.

OPSEU, CUPE and OLBEU believe that the plan should be designed through negotiations and could be amended without reference to legislation. In their opinion, such new arrangements would lend themselves to more responsible pension cost and benefit determination.

The OPPA tell us that they are in litigation to establish pension negotiations. As this matter is before the courts, the OPPA considers pensions non-negotiable but believes that pensions must be formally discussed with the employer.

Determinants of Long Term Costs

Risk/Reward

OPSEU, CUPE and OLBEU see different types of risk associated with pension plan participation. Their position is that employees share pension risks with employers. Thus, employees could risk both having the value of their pension benefits decline with inflation and contributing to a pension that does not yield investment returns as large as those that may have been possible under private savings. These unions believe that their membership share a significant portion of the overall pension risk because they contribute to their pension plan and because the value of the pension benefit is sensitive to inflation.

OPSEU, CUPE and OLBEU stress that an employer could only bear all of the funding risk in a pension plan if the plan were non-contributory; if the actual benefit value delivered remained stable regardless of the rate of inflation, both pre- and post-retirement; and if increased costs were never charged against other elements of total compensation in negotiations. These unions believe that any extra pension contributions made by the plan sponsor would be reflected in subsequent compensation schedules.

Real Rates of Investment Return

The OPPA believes that future real rates of investment return on pension funds could be between three and five per cent real under a diversified investment program.

Paying for Pension Costs

Funding Policy

The OPPA's preference is to have the PSSAF continue with a modified "pay-go" funding basis, combined with a contribution increase. The OPPA is reluctant to move to full funding immediately and believes that with improved investment returns and a one per cent contribution increase, positive cash flows are possible well into the 21st century. Its view is that with successful investment, the fund may be able to move over time to full funding.

Financing Past Service Liabilities with Respect to Cost Sharing Distribution and Amortization Arrangements

The OPPA believes that the government is responsible for past service costs regarding retirees' inflation protection prior to 1976.

Merging Policy

OPSEU, CUPE, OLBEU and OPPA support amalgamating the PSSF and PSSAF. The OPPA thinks that the merging of the PSSF and the PSSAF would have administrative value and would put into practice what its membership now believes is in place. The OPPA believes that the amalgamation of the PSSF and the PSSAF would have long-run benefits and that with the basic plan being healthy, any surplus in the basic plan could totally or partially offset negative SAF cash flows.

Setting Contribution Rates

Setting contribution rate comments are placed in the following sub-categories: contribution rate assessment; impacts of actuarial/economic methods/assumptions/projections; cost sharing distribution; and surplus/deficit policy.

Contribution Rate Assessment

OPSEU, CUPE and OLBEU are concerned that lower wage employees are contributing more towards the cost of indexing of their benefits than higher salary employees. They do not believe a contribution rate increase is necessary.

If the PSSAF continues on a modified "pay go" funding basis, the OPPA recommends a contribution increase equal to one per cent of earnings by employees and by employer, effective January 1, 1989. If full funding of indexing is adopted in the near future, the OPPA would be prepared to pay the increase noted with an additional 1/10th of one per cent until 1999 or until full funding is reached. The OPPA would not agree to an increase beyond funding requirements and they would want to monitor and review the status of funding under a firm, regular and careful program.

OPSEU, CUPE and OLBEU said that if a six per cent contribution rate was considered reasonable in 1967, with assumptions then covering all but two to three per cent of inflation, in today's situation a seven per cent contribution rate should be sufficient because pension costs to fully index pensions are lower today.

- **Impacts of Actuarial/Economic Methods/Assumptions/Projections**

The position of OPSEU, CUPE and OLBEU is that the financial and actuarial assumptions used to cost and value indexed pension benefits can be biased towards needlessly high contribution rates. They do not want contributions to be determined on an "entry age normal" basis but believe that the plan should continue to be costed and valued on a "unit credit" basis.

OPSEU, CUPE and OLBEU's position is that because pension costs are extremely sensitive to minor economic and actuarial assumption variations, and the current practice for setting the assumptions is excessively cautious, there is not a case for contribution increases.

OPSEU, CUPE and OLBEU compare the public service plan to other major public and private sector plans which invest in the market and provide inflation protection equal to 50 - 60 per cent of CPI without additional contributions to a separate fund. They point out that these plans also have substantial actuarial surpluses.

- **Cost Sharing Distribution**

OPSEU, CUPE and OLBEU said that they believe that employee contributions are borrowed by the employer at rates significantly lower than market investments would bring.

OPSEU, CUPE and OLBEU believe that the employer exploited the PSSAF to reduce its obligation to the main fund. They explain that recent unexpected investment gains have enabled the employer to eliminate a major part of its ongoing contributions to the fund, specifically, the portion required to catch up on funding of previous years accrued liabilities. OPSEU, CUPE and OLBEU believe that the elimination of these payments has resulted in long term employer cost savings. They say that the employer cost savings are greater than the short-term negative plan experiences created during the 1970s, which the employer covered.

In response to the Coward report and the Rowan report recommendations regarding sharing costs, OPSEU, CUPE and OLBEU believe that, considering the PSSF funding basis, the employer should expect to contribute more than employees on an ongoing basis. Specifically, if the PSSAF had not been introduced, the employer would have made ad hoc inflation adjustments and would not have reduced its special payments. Today, the employer would be making higher contributions than employees. These unions also point out that comparable public sector employers expect to pay more than employees on an ongoing basis, for example, the Hospitals of Ontario Pension Plan (HOOPP).

OPSEU, CUPE and OLBEU do not believe there is a basis for presuming one half of the pension cost should be borne by employees. They say that, without negotiations, the employer unilaterally decided to fix employee costs below one half of the full cost of benefits earned.

The OPPA position is that they have always favoured joint funding on an equal cost sharing basis with the employer.

- **Surplus/Deficit Policy**

  OPSEU, CUPE and OLBEU believe that legislation should prohibit employer contribution holidays and surplus withdrawals. They point to using surpluses exclusively to improve benefits for current and future pensioners. They want surplus/deficit allocations to be decided in the negotiation cycle which determines the total compensation package. OPSEU, CUPE and OLBEU believe that this is the only effective, appropriate way to share risk/reward of a defined benefit deal.

Investment Policy

Market Investments

OPSEU, CUPE and OLBEU support the investment of funds in marketable securities. They believe that employee pension contributions are borrowed by the government at rates significantly lower than what market investments would provide. With diversification, as recommended by OPSEU in 1976, they believe that the fund could have increased by $1.5 billion beyond its present value. Their opinion is that the present investment policy places an unnecessary burden on taxpayers and results in benefit costs being overstated.

OPSEU, CUPE and OLBEU believe that funding has been a secure source of financing for important public policies and that it seems reasonable to consider a schedule of PSSF funds to be invested in Ontario government bonds, at market interest rates, as part of a prudent portfolio, for three reasons. Such investment would add security to the investment portfolio; would ensure that the government need not meet all its borrowing needs through the marketplace; and, would ensure that cash flows are slowly fed into the marketplace without major disruptions to capital markets.

OPPA recommends that the government immediately establish a market-based investment portfolio structured similarly to successfully managed funds.

OPSEU, CUPE and OLBEU are opposed to centralizing pension funds with other public sector pension funds.

Capital Market Impacts

OPSEU, CUPE and OLBEU want the 10 per cent limitation on foreign investment of pension funds to be maintained.

Investment Management

OPSEU, CUPE and OLBEU believe that different investment strategies may be suitable to meet the needs of different plan participants. Active members may have an investment strategy aimed at long term objectives while retireds may benefit from investments being hedged against increased inflation in the short term. This form of investment strategy would allow funding to be addressed in a direct manner.

At this time, the OPPA was not prepared to recommend to us the manner in which an investment fund should be managed by plan participants.

Social/Political/Ethical/Economic Enhancements/Investments

OPSEU, CUPE and OLBEU believe that the government can and should require all pension plans to invest in specified social objectives. They want investment strategies to reflect the interests of all parties who have a stake in the security and economy of the plan.

OPSEU, CUPE and OLBEU recommend that a process be created to consider investments other than those indicated by conventional, technical factors. They further recommend that this process include equal employee/employer representation.

❐ *Governance/Structure*

❐ *Benefits Policy, Fund Investment, Plan Administration Elements*

OPSEU, CUPE and OLBEU want the pension fund structure to reflect employees' currently shared pension risk. They want, through a board of trustees, equal representation on all aspects of the plan. A board of trustees is seen by these unions as an opportunity to separate plan provisions and the day-to-day fund/plan management.

If investments are diversified, the OPPA wants to be consulted on determining the structures for administration, monitoring and investment portfolio direction.

❐ *Fiduciary Concerns*

Fiduciary concern comments are placed in the following sub-categories: fiduciary responsibility; conflicts of interest; and arm's length relationships.

❐ Fiduciary Responsibility

The OPPA wants the government to maintain general overall control of the fund. OPSEU, CUPE and OLBEU want the defined benefit to continue to be guaranteed.

❐ Conflicts of Interest

OPSEU, CUPE and OLBEU want the government to separate its role as legislator from its role as employer. Specifically, they want the government to act as an employer not a legislator in its dealings with the public service pension plan.

❐ Arm's Length Relationships

OPSEU, CUPE and OLBEU want the plan to be governed by an arm's length board of trustees. These unions believe the taxpayer would be represented by the employer and pensioners by employee representatives.

SECTION III

❐ *Administrators' Views*

This section reviews comments received from plan administrators. We met with the Teachers' Superannuation Commission (TSC) and received their views in both a submission and in informal discussions. From its perspective as plan administrator, the TSC confined its brief to the pertinent aspects of the Rowan and Coward reports affecting the administration of the teachers' plan.

❐ *Determinants of Long-Term Costs*

❐ *Real Rates of Investment Return*

The material provided by the TSC highlighted an anomaly between the long-term rate of investment return for the TSF and the significantly higher coupon rates recently enjoyed on new cash flows. This, coupled with a substantial decline in inflation, has yielded a marginal real rate of return much higher than the average real rate as outlined in the Rowan and Coward reports.

❐ Paying for Pension Costs

❐ Merging Policy

The TSC emphasizes that significant long-term administrative benefits could be realized from the merger of the TSF and TSAF.

❐ Investment Policy

❐ Capital Market Impacts

The TSC agrees with Rowan recommendation 5.6 that the government should request the Federal Government to raise the foreign property limit contained in the income tax act above 10 per cent. The TSC approach would be to invest in the Canadian market at the start of investment diversification, with a move towards investing in the United States market as the investment management process matured.

❐ Investment Management

The TSC believes that the Rowan report recommendation to start investment diversification on January 1, 1989 is too optimistic and that a January 1, 1990 date is more realistic.

❐ Governance/Structure

❐ Administration Elements

If investments are diversified, the TSC believes it is crucial to have enough time to carefully develop policies and put administration arrangements in place.

SECTION IV

❐ Central Labour Bodies

This section reviews comments received from central labour bodies. We met with the Ontario Federation of Labour (OFL) and received their views in both informal discussions and at our seminar.

In its capacity as a central labour body the OFL does not directly undertake negotiations with employers. That function is carried out by the OFL's affiliates. It is not the role of the OFL to determine the shape of individual members' pension plans or the financing of those plans, but to involve themselves in issues of public policy. The OFL participation in our Consultations was confined to public policy issues.

The OFL's response to our request for a submission covered: the continuation of the modified "pay-go" arrangements, the validity of imposing social objectives on pension investments, financing inflation protection, and pension fund surplus entitlements.

❐ Future Pension Benefit Program

❐ Membership, Total Compensation and Risk Relationships

The OFL states that the employer does not bear 100 per cent of the ultimate incidence of risk in defined benefit pension costs because no element of an employer's compensation package is determined in isolation of its other parts. It says that any higher cost on a "non-wage" item will be reflected in wage settlements.

Paying for Pension Costs

Funding Policy

The OFL believes that funding policy decisions should be left to the pension plan parties. The OFL does not believe that any public policy is served by prohibiting "pay go" financing in the public sector. The OFL believes that a modified "pay go" financing approach may provide both greater stability and predictability to contribution rates than pre-funding driven by variations in investment yields.

If modified "pay go" financing was continued, the OFL recognises that contribution rates would have to be modified from time to time. They favour mandatory review of benefit and contribution rate levels every five years in order to ensure that these relationships are correct. The OFL believes that any review mechanism must be mandatory and firm, with representation from employees, government officials and actuarial support.

Setting Contribution Rates

The OFL's comments related to setting contribution rates are placed in the following sub-categories: contribution rate assessment; and surplus/deficit policy.

Contribution Rate Assessment

The OFL says in establishing SABA, the government and the employees recognized that there would be some degree of variability in the aggregate contribution rate since the demographic basis for the initial contribution rates could not be presumed to endure indefinitely. The OFL does not believe that there is likely to be any dramatic upward ratcheting of aggregate contribution rates.

Surplus/Deficit Policy

The OFL analyses fund surplus in the following way. It sees three elements in investment yield: 1) real return on capital, net of risk and inflation; 2) inflation induced return; 3) residual attributable to acceptance of a degree of investment risk. Surplus adjustments from any impacts of demographic assumptions on a plan's liability structure must also be considered.

The OFL would allow any surplus arising from the real return on capital, net of risk and inflation, to be applied towards the plan sponsor's normal cost. Any inflation-induced return should be used to finance inflation adjustments for current pension recipients as well as vested deferreds. Finally, any return associated with changes in plan demographics or with risk acceptance should be applied towards prudential reserves and plan improvements.

Funding Reserve Policy

The OFL recommends a prudential reserve policy which would cushion the plan against adverse investment or demographic changes. It believes that a prudential reserve policy reduces the degree of short-term risk associated with plan sponsorship.

Investment Policy

Capital Market Impacts

The OFL agrees with the present 10 per cent federal income tax limitation on foreign investment. The OFL would agree to lowering the current foreign investment ceiling, or even to barring foreign investments.

❒ *Social/Political/Ethical/Economic Enhancements/Investments*

The OFL believes that the government has a right to impose social requirements on pension investments because it foregoes tax revenue on pension earnings/contributions. The OFL recommends that the government not constrain any pension fund from contributing to social objectives and that the rights of public employees to make social investments not be diminished.

The OFL believes that all pension plans should be required to exercise greater social discipline but that public employee plans should not be required to have greater social investing obligations than other employment pension plans.

SECTION V

❒ *Views of Other Interested Organizations and Individuals Submitting Briefs*

This section reviews the comments we received from 22 interested organizations and members of the public. Submissions were received from such organizations as the Association of Canadian Pension Management (ACPM), the Canadian Bankers' Association (CBA), the Canadian Chamber of Commerce, the Ontario Chamber of Commerce, Scotia McLeod (previously McLeod Young Weir Limited), Midland Doherty Limited, the Toronto Stock Exchange, the Ontario Public School Trustees' Association (OPSTA), Ryerson Polytechnical Institute, Task Force on the Churches and Corporate Responsibility, the National Citizens' Coalition and Teachers' Money Matters.

The organizations and members of the public who submitted briefs hold a variety of views. Their comments can be placed in the following categories:

- ❒ Future pension benefit program
- ❒ Determinants of long-term costs
- ❒ Paying for pension costs
- ❒ Investment policy
- ❒ Governance/structure

While there are wide differences of opinion among the submissions outlined in this section, we found five areas with apparently general agreement. They are as follows:

- Although not universally agreed to, there is a strong acceptance of investing teachers' and public servants' pension funds in marketable and diversified investments.
- Good employment-based retirement income savings arrangements are important.
- Pensions need some form of inflation protection. However, there are many different opinions on how to pay for inflation protection, who should pay for it, and what level of protection is needed.
- Teachers' and public servants' pensions are generally viewed as more generous than those provided by the private sector and most believe that there should be more parity between the private and public sectors. We would point out that it does not seem to be generally recognised that teachers and public servants make higher contributions towards their pensions than most other pension plan participants.
- Employee representation is important in pension fund decision-making.

❐ Future Pension Benefit Program

❐ Basic Benefits - Design and Level of Indexation

Some individuals resent what they see as inferior treatment because of a lack of uniformity among public sector plans. Others advocate greater parity between public and private sector plans. In particular, these individuals want teachers' and public servants' pensions to be less generous, especially in the area of inflation protection.

Many of the individual submissions stress the importance of improved pension portability and more flexible retirement savings arrangements. They feel retirement savings should provide income which supports the continuation of pre-retirement lifestyles after retirement. One submission is of the opinion that teachers' and public servants' pension benefits are well above the level that is needed to continue a pre-retirement lifestyle.

The National Citizens' Coalition supports giving public servants the freedom to arrange and contribute to their own retirement savings arrangements, as an alternative to the employment based plan. The Coalition emphasizes that the government should provide the same levels of contributions to these arrangements as they would to the employment plan.

❐ Level of Indexation

CBA prefers public sector plans to parallel and not lead the private sector and, therefore, would rather that future inflation protection for teachers and public servants to be at the level proposed in the Friedland proposal. The National Citizens' Coalition also supports the principle that public sector pensions should parallel and not lead the private sector.

The Canadian Chamber of Commerce believes that the current commitment to inflation protection for teachers and public servants was made without full public information on associated costs. Given this situation, it feels that the concept should be re-addressed.

The Ontario Chamber of Commerce does not want teachers and public servants to have inflation protection above the level which may be mandated for private sector plans.

Teachers' Money Matters advocates retaining the current level of inflation protection for teachers' pensions.

❐ Total Compensation

Some of the individual submissions are supportive of pensions being considered in a broader compensation framework. One brief believes that the government employee compensation structure is too generous and, consequently, private sector employers are not able to compete effectively in recruiting employees.

The Association of Canadian Pension Management (ACPM) emphasizes that the cost of pension benefits should be assessed in a total compensation context. The Ontario Chamber of Commerce also supports having employees and employers understand that pension benefits and contribution levels are parts of the total compensation contract.

The Ontario Public School Trustees' Association (OPSTA) is strongly opposed to province-wide bargaining for teacher salaries and benefits as they see local responsibility being critical to local school board autonomy. The OPSTA believes that any consideration to change the current arrangement must be carefully discussed with school boards.

OPSTA wants teachers' salaries and benefits to be viewed in a total compensation context. It believes that because pensions are not considered in light of other compensation, teachers' compensation packages are substantially undervalued. OPSTA recommends that, in order to communicate accurate assessments of total compensation paid, the Education Relations Commission should maintain and distribute information on the value of pension benefits.

Determinants of Long-Term Costs

Real Rates of Investment Return

Scotia McLeod has concluded that an assumption of a two per cent real rate of investment return on an existing pension fund portfolio is an absolute minimum. This level of return has been attainable over the last 15 years on unmanaged investments in virtually any class of securities. To expect a three per cent real rate of return on marketable securities is not unreasonable over time but may require judicious management to achieve it year by year. Scotia McLeod maintains that investment returns greater than a three per cent real rate of investment return, in any but the most recent investment history, have required a substantial concentration of equity investment.

Midland Doherty provided the Consultations with a useful paper on the experience of inflation and investment returns, from various alternative assets of relevance to pension fund investments.

Actuarial Assumptions

Teachers' Money Matters strongly believes that the actuarial assumptions used to value and cost the TSF/TSAF are very conservative. It further states that if less conservative assumptions were used both the TSF's actuarial surplus and the TSAF's assets would be greatly increased. In support of these views, Teachers' Money Matters points out that while the actuaries projected 9.6 per cent investment earnings for 1988, the actual rate of return will be approximately 11 per cent. It further notes such a difference would have a tremendous impact on the TSF's actuarial surplus.

Paying for Pension Costs

Funding and Merging Policy

Both the ACPM and the OPSTA support the merging of the SAFs with their respective basic funds. Ryerson is not opposed to either merging the Ryerson SAF with its pension plan or maintaining the present SAF arrangement. If SABA continues, Ryerson wants to be able to continue to independently monitor the Ryerson portion of the SAF.

Teachers' Money Matters does not support merging the TSF and the TSAF at this time but recommends that independent actuarial studies review the TSAF at five-year intervals, beginning in 1990. Such studies should take into account both the TSF and the TSAF. It further recommends that one-half of any TSF actuarial surplus should be held in reserve for the TSAF, if required.

CBA, the Canadian Chamber of Commerce, the Ontario Chamber of Commerce, and the National Citizens' Coalition believe that all pension benefits, including inflation adjustments, should be funded under the same rules as the private sector.

Ryerson agrees that, in principle, full funding is a desirable goal. Ryerson wants any past service unfunded liability related to the Ryerson Superannuation Adjustment Fund (RSAF) to be eliminated by the government in order to place a newly merged arrangement onto a financially healthy basis.

Financing Past Service Liabilities with Respect to Cost-Sharing Distribution and Amortization Arrangements

CBA accepts the Coward report recommendation that past service unfunded liabilities should be paid by the government over 15 years, or 25 years if permitted. The Canadian Chamber of Commerce recommends that, after merging the SAF's with their respective basic funds, any resulting unfunded liabilities should be funded over a period of 15 years, or 25 years if permitted. Ryerson wants the government to fund the past service unfunded liability related to the RSAF.

OPSTA does not want the government to pay for all of the past service unfunded liability related to the TSAF if teachers can be asked to make up part of the shortfall. The OPSTA would like to know what proportion of the unfunded liability can be attributed to teachers' underfunding and how this amount can be recovered through teachers' contributions.

Scotia McLeod recommends that a program of expeditiously reducing unfunded liabilities would be of considerable value in preserving Ontario's provincial credit rating since rating agencies and other credit analysts are becoming increasingly conscious and critical of such liabilities. While a substantial unfunded pension obligation would not of itself trigger a rating change, it would likely become an increasingly important marginal factor.

❐ Setting Contribution Rates

ACPM says that the present one per cent employee/employer SAF contribution rate is totally inadequate and believes it is critical for taxpayers to understand both current costs and any future pension debts being incurred. The CBA wants member contribution rates to be increased as recommended by the Coward report. If SABA continues, Ryerson would not be opposed to a contribution increase if required.

The Canadian Chamber of Commerce believes that financing should be predicated on equal employee/employer cost sharing. It proposes cost sharing through one or more of the following: an equal increase in contribution rates; recognition of the value of the pension component in the collective bargaining process; modification of the present benefit levels. The Ontario Chamber of Commerce supports proper cost allocation between employees and employer. OPSTA supports continuing the current level of inflation protection for teachers only if they pay one-half of the full and true cost of their pension benefits.

❐ Investment Policy

❐ Market Investments, Capital Market Impacts

Many support investing teachers' and public servants' pension funds in marketable and diversified investments.

The Ontario Chamber of Commerce supports investing teachers' and public servants' pension funds in marketable securities. Ryerson also supports this action. Ryerson further recommends that the government consider converting existing non-marketable Ontario government debt into market investments. The OPSTA supports investing teachers' pension funds in marketable securities.

The Canadian Chamber of Commerce does not support investing teachers' and public servants' pension funds in marketable securities. They think that the disadvantages outweigh the advantages and that external indicators could be used to determine the contribution rates, independent of an actual fund investment policy.

CBA supports investing public sector pension funds in marketable securities under the same rules as the private sector. However, it wants public sector pension investments to be passive and restricted from either exercising control or influencing corporate strategy.

Scotia McLeod believes that with skillful execution, diversification of teachers' and public servants' pension funds will not be disruptive to capital markets.

Teachers' Money Matters wants the diversification of teachers' annual surpluses and teachers' maturing non-marketable Ontario government debt to proceed immediately to marketable securities, as recommended in the Rowan report.

ACPM supports investing TSF/TSAF and PSSF/PSSAF assets in market investments. It does not want further centralization of public sector pension funds or the government directing public sector pension funds to make specific kinds of investments.

The Ontario Chamber of Commerce does not want public sector pension funds to be further centralized. In addition, the Ontario Chamber of Commerce recommends that the federal government be asked to raise the foreign property limit in the income tax act to 20 per cent.

The Toronto Stock Exchange wants the teachers' and public servants' pension funds to be invested in market investments. It believes that these major pools of savings belong in Ontario's capital markets and that investing these funds in the market will benefit Ontario's economy and long-term financial health. The Exchange says that market investments will provide the best return for a given level of risk and that through market investments, scarce funds are allocated to their best use.

The National Citizens' Coalition believes that the interest credited to the indexation funds should not exceed the average return typical among the 25 largest private sector pension funds.

❑ *Social/Political/Ethical/Economic Enhancements/Investments*

CBA believes that the maximization of long-term investment returns for plan members should be the basis of public sector investment policy. In its view, the achievement of social or economic objectives should be a determining factor in the investment decision process, but only as a by-product, because this approach would be a violation of fiduciary responsibility.

The Ontario Chamber of Commerce supports fund maximization as a primary investment policy and does not want the government to be able to direct investment decisions toward political objectives. OPSTA also supports investing for fund maximization.

The Canadian Chamber of Commerce's opposition to investing teachers' and public servants' pension funds in marketable securities is based on its scepticism about the government's ability to remain at arm's length from fund investment decisions. It wonders if the government will be able to withstand pressures to exert political influence. In addition, the Canadian Chamber of Commerce is concerned with the ability of capital markets to absorb these funds successfully and profitably.

The Task Force on the Churches and Corporate Responsibility supports the position that the government should not be directing public sector pension funds to make particular kinds of investments. However, it emphasizes that socially responsible investing is a prudent standard of care for all pension funds. The Task Force recommends that public sector plan trustees should be encouraged to form "social responsibility" investment committees, similar to other types of investment sub-committes. The social implications of the plans' investments should be discussed in the trustees' annual report to plan members. The Task Force does not believe that "concessionary investing" would be generally possible in an ordinary pension plan.

❑ *Governance/Structure*

ACPM supports better taxpayer representation and plan member participation in pension fund decision-making. It believes that the TSF and the PSSF should be established as separate arm's length pension funds, governed by the same rules as those applied to the private sector.

The Ontario Chamber of Commerce believes that employees and employers should have a mechanism to provide for free exchange of ideas on the pension plan. It further recommends that the teachers' and the public servants' plans should be administered by a board of governors, made up of employee and employer representatives. The board responsibilities should include pension administration and fund investments. It believes that this structure would ensure that the fund is separate from regular employee and employer responsibilities.

The Task Force on the Churches and Corporate Responsibility supports plan member involvement in plan administration and investment management. The Task Force wants all trustees to be bound by the same standard of care as private sector pension trustees. Its principal reason would be to guarantee, for the trustees, independence from the government and possible undue political influence. The Task Force further recommends that, since trustees act on behalf of the all membership interests, trustees should develop mechanisms to determine the concerns and priorities of all pension plan members.

Teachers' Money Matters recommends striking a new pension deal to give teachers full responsibility for their pension funds. It supports establishing the TSF and the TSAF at arm's length from the government and contributors. It further recommends that any board or commission should have equal representation from active contributors, the government and one representative from the Superannuated Teachers of Ontario (STO). Teachers' Money Matters wants active contributors and retired teachers to elect their representatives by a province-wide ballot.

OPSTA believes that local school boards are impacted both financially and in their human resource management flexibility by pension decisions. Therefore, OPSTA recommends that school trustees be represented, in a non-voting capacity, on the TSC, or its successor in order to add a further perspective to pension decisions and to have some link between pension discussions and other compensation discussions.

CHAPTER 4

On Our Own Initiative

Introduction

This chapter reports on what we have learned through discussions and reviews initiated by us. We wanted to find out what experienced persons thought about such matters as governance and structure of pension programs in Canada, as well as funding, investment performance and expectations, indexation and contribution rates. Our primary interest was to learn from others' experience pertaining to the proposals for change of the pension programs for teachers and public servants in Ontario.

Those interviewed include: representatives of major Ontario public sector plans; a number of large Ontario and other Canadian private sector pension plans; labour organizations concerned with Ontario public sector pension plan participants; a substantial number of Canada's most experienced firms of investment counsellors and fund managers with public and private sector pension fund experience; investment dealers; many of Ontario's large and medium-sized employee benefit and actuarial consulting firms; individual actuaries; representatives of the Canadian Institute of Actuaries; academics; insurance companies; a number of public sector pension plans elsewhere in Canada and the United States, and representatives of provincial and federal pension and income tax regulatory authorities. See Appendix C for a list of our visits.

We sought and received technical advice from the ministries of the government of Ontario which administer the plans. We did not seek their advice on policy matters, because the report of the Consultations is intended to be independent of the policy views of the government.

We reviewed a great deal of pension literature, including the extensive and helpful research materials prepared for the Rowan and Friedland Task Forces. Some memoranda were commissioned which are noted in the list of background papers at the front of this report. Advisors and authors of published Consultations memoranda are Professor James Pesando, Keith Ambachtsheer, Shiraz Bharmal, Peter Hirst, Dr. David Conklin and Dr. Douglas Auld and Dr. Harry Kitchen.

Chapter 4 has seven sections and they are:

I **Questions we asked**
II **Major decisions for the pension principals**
III **Governance, structure and collective bargaining**
IV **Funding**
V **Investments**
VI **Indexation**
VII **Contribution rates and their determinants**

A few general observations are appropriate before turning to the details contained in this chapter.

- Most persons interviewed were generally aware of the major changes proposed for the teachers' and public servants' pension programs; transformation of the programs into large trusteed pension plans at arm's length from the government; investment in diversified market portfolios; fully funded targets; and regulations similar to private sector plans.

- We were told that there is much successful Canadian public and private experience with respect to each issue which would arise if the proposed transformations were made. That experience provides a great deal of reassurance concerning ability to achieve the goals of proposed changes.
- We were also offered many favourable opinions concerning the desirability of the proposed transformations.

SECTION I

❒ *Questions we asked:*

❒ *Pension Decisions and Pension Trends*

- *What are the current and emerging trends in designing attractive and sound retirement income programs?*
- *In defined benefit programs, what are the principal decisions which have to be made, no matter what the governance of the program?*
- *If the design of teachers' and public servants' pensions were to be fundamentally reviewed, what would an attractive and feasible program look like - in view of emerging trends?*
- *What is Ontario's evolving experience in considering pension benefits as deferred compensation?*
  - *Are benefits provided by Ontario's pension plans typically considered capital transfers/deferred income in total compensation packages?*
  - *What choices are employees offered in trading off different elements of compensation?*
  - *Within retirement income programs, what choices can be made among various elements of the program?*

❒ *Participation, Responsibility and Collective Bargaining*

- *What is the current Ontario experience of the roles of employers, employees, employee representatives and pension trustees in public and private sector pension programs?*
- *Over time, how have these roles changed?*
- *What important insight into possible future forms of governance of pension programs for teachers and public servants is suggested by the governance of other public and private sector programs in Ontario and Canada?*
- *What has been the role of negotiability and collective bargaining of pension matters in Ontario in public and private sector programs?*
- *How has collective bargaining and trusteeship of members been reconciled?*
- *What lessons are suggested by this experience for the proposed changes of the teachers' and public servants' programs?*

❒ *Funding*

- *For plans with significant funding levels, what principles and practices govern the relationships between benefit liabilities, investment policies/performances, and contribution rates, to ensure secure and effective pension programs? What alternative models exist and what relevance do they have for the subject of the Consultations? What are the principles and practices for dealing with unfunded liabilities in private and other public sector pension programs?*
- *What are the principal reasons for financing public sector and private sector pension programs on either fully-funded or modified 'pay-go' bases? If a modified "pay-go" financing approach is decided, what have been the targets for the financing levels, the pace of adjustment, and the mechanism for achieving the target? Have modified "pay-go" approaches been successful? or successful under some circumstances? What circumstances?*

❒ *Investments*

- *If pension funds are invested in marketable instruments, what investment strategies are usually applied to manage the funds? How do the investment approaches differ in their impacts on investment returns and on a pension program's financial stability?*

- *Is it financially prudent for a pension plan to aim for either moderate or high levels of long-term investment returns which entail both more investment risk and performance volatility than 'low risk' investment strategies? What are the accepted principles to cope with volatility, particularly if considerable stability and predictability of benefits and contribution rates are sought?*
- *In view of the history of investment returns, particularly during the last 25 years, what are reasonable targets for investment returns, risk levels, and volatility for diversified market public sector pension fund portfolios?*
- *If a pension program adopts an investment strategy that is likely to produce period of both "bad news" and "good news", how bad might the bad be and how good might the good be? What might be required in adjustment of contribution rates or benefits over periods such as five years to compensate for the "bad news"? What might be the rewards to be shared over periods such as five years from "good news" experience, particularly of investment performance?*

❒ Indexation

- *What is the cumulative evidence of "ad hoc" indexing in Ontario of private and public sector pension plans; as to effectiveness for pensioners; as to costs; as to requirements of pension fund management?*
- *What would be the cost impacts of contractual indexing, at varying levels, on unindexed pension programs? What are the expectations of the effects of mandatory indexation if it is invoked in Ontario?*

❒ Contribution Rates and Their Determinants

- *How cautious are the actuarial assumptions used to cost and value pension funds in Ontario? What ranges of actuarial assumptions appear to be acceptable to the regulatory authorities and what are considered good practice by the Canadian Institute of Actuaries?*
- *Are the assumptions moving away from "conservative" bases toward "realistic" or "best estimate" ones? - quickly or slowly? Are the gaps large or small and what difference do they make to valuations and costing of pension programs?*
- *Is a risk-free rate of investment return considered an appropriate measure to cost and value fully indexed pension benefits? If so, in light of historical experience, and emerging indexed capital market instruments, what is an appropriate risk-free real rate of investment return to use to cost and value fully indexed defined benefit pension benefits?*
- *If employees and employers base their contribution rates on an equal cost-sharing basis, what are the alternatives and experience to make adjustments in contribution rates in response to either favourable or adverse financial and actuarial experience in pension programs?*

SECTION II

❒ Pension Decisions and Pension Trends

The purpose of this section is to report on pension decisions and trends that were prominent in the discussions.

We did not encounter any expectation that the proportion of retirement income provided by the Old Age Security (OAS)/Guaranteed Income Supplement (GIS) and the CPP programs to persons who are in employment for most of their adult lives is likely to be increased much in the immediate future. Thus employment-based retirement income programs and personal savings programs are expected to continue as major elements of the pension system for both the public and private sectors in Ontario.

It is recognized that in Canada many people have inadequate pensions or none at all. Marginal improvements in the public system to address these deficiencies are expected some time in the future but employment-based programs for the majority of workers are expected to persist for a long time.

The impact of the gradual increase in employee and employer contribution rates to the CPP over the next two decades has not been generally realized. These increases will eventually be large. They will not provide improvements in pension benefits as a proportion of average industrial wage at retirement. Depending on the integration of contribution rates and benefits of the CPP and employment-based programs in Ontario, either total contribution rates to pension plans will increase, or the residual contribution rates and the benefits from employment-based pensions will decrease in Ontario.

Until recently, defined benefit pension plans have been overwhelmingly the most popular programs for employment-based plans. Tax policy was a major factor in supporting these preferences, particularly for the private sector. For individuals, tax policy encouraged retirement savings, particularly in pension plans for both private and public sector employees. Defined benefit programs were easily understood and were predictable. In general, adequate flexibility could be built in to the employer's contribution schedule, including amortization of unfunded liabilities over reasonable periods of time.

Recent trends show greatly expanded interest in hybrid retirement income programs containing a component of a defined benefit program (often now non-contributory for the employees) and a component of a defined contribution program (maybe as a group RRSP), with most of that component being paid for by the contributions of members. Proposed changes in federal tax policy are intended to produce a regime which is more neutral for persons as between pension programs and other forms of saving and among different pension programs.

The uncertainty about the use of pension fund surpluses, even as a mechanism to cope with transitory unfunded liabilities, is apparently discouraging some employers from putting all their pension "eggs" in the defined benefit "basket". Limitations for tax purposes on surplus accumulations in pension funds may reduce the capacity of pension plan sponsors to cope with the rigidity of defined benefits on the one hand and market volatility on the other. The potential burdens of mandatory indexation of pensions, as well as increased costs of vesting and portability provisions under defined benefit programs, also appear to discourage the popularity of defined benefit programs which existed in the past.

However, the attractions to all parties of defined benefit programs are still great, particularly for those with terminal year averaging and a significant degree of indexation of pensions. Even in hybrid plans, the defined benefit components continue to play a major role. The message received was essentially that there is general concern about finding ways to cope with the new regulatory requirements. This concern is seen to be particularly relevant if there is continuance of defined benefit programs at the core of the system, rather than abandonment of such designs altogether.

In searching for ways to sustain the defined benefit programs to meet the requirements of pension reform, and to meet the new tax regulations, the whole range of major decisions concerning pension programs is under review. The re-examination of retirement income programs is one of the most active growth industries in the country at this time.

In the reviews, major decisions have to be taken regarding:

- **Compatibility of Contribution, Benefits, and Investment Policy**

- **Within Contribution Policy:**

  - Who contributes, by how much and for what?
  - What are the funding aims and the pace of meeting the funding targets?
  - What are the adjustment mechanisms to determine who shares in rewards and responsibilities for the pension program's financial health?

- Who is responsible for unfunded liability/experience deficiencies and their amortization schedules?

- **Within Benefits**

  - The compromise between basic benefit levels and indexing levels
  - Contractual or "ad hoc" inflation protection for pensions
  - Benefit formulae
  - Ancillary benefits
  - Options on termination
  - Early retirement entitlements
  - Interrelationship of benefits and family status
  - Treatment of retireds

- **For Investments**

  - Target for investment return and acceptance of risk
  - Risk tolerance
  - Mechanisms and policies to cope with variability/volatility of investment performance over the short and long term life of the pension programs

SECTION III

❐ *Governance, Structure and Collective Bargaining*

Employee participation and responsibility within pension programs in Canada now range from no participation to full partnership. This is true for both contributory and non-contributory defined benefit plans and for hybrids.

Four archetypal models span the range of employee participation and responsibility which now exist in Canada. These are:

❐ *Employer Paternalism*

Employees do not hold any real power or share in the responsibility for the pension program. Except for an implicit relationship of pension costs to other elements of compensation, employees bear none of the risks of the program. Collective bargaining on pension matters may exist, but it is the exception, not the rule. Employees may contribute to the pension fund but they have no real say in decisions about the pension program.

The pension programs may aim for full funding. In this model, it is usually argued that, since the employer bears the total responsibility for unfunded liability, the employer is entitled to all the surpluses which may develop. However, as the research papers of the Friedland Task Force show, the subject is moot in Ontario.

Many private sector pension programs currently existing in Canada are best described by this model. At least one of the successful public sector pension programs in Ontario falls into this model, as we see it, as well as a number of public sector programs in other provinces.

- ***Employer Paternalism, with Limited Employee Participation and Responsibility***

As in the previous model, employees do not hold real power or share in the responsibility for the pension program. Employees may have some involvement in the policy or the administration of the pension program, either formally or informally, through the good will of the employer. The involvement is typically limited to: representing and advising on employee needs; having some input to changes in pension benefits; and sharing in education, communications and administration. Pensions are not usually part of negotiations on salaries, benefits or working conditions, but some pension matters may be formally discussed from time to time.

This model describes most of the public sector pension programs in Ontario and in the rest of Canada from their origins through the early 1970s. In our view, several public sector programs in Ontario still fit into that mold, although it now describes much more the private than the public sector.

Even in the public sector in Ontario, the increases in participation and responsibility permitted to members have been slow, piecemeal and hesitant, particularly for the public service, a sector which is one of our main concerns.

- ***Shared Participation and Responsibility - Limited, Partial or Selective Partnership - And/or Some Negotiability or Collective Bargaining***

Several sub-models of shared participation and responsibility now exist and others have been recommended for public sector pension programs in Ontario.

In trusteed programs, the members or their representatives may be a minority of a board of trustees which has overall responsibility for the program within the framework agreed to by the representatives of the principals.

Alternatively, the members may participate in the decisions and responsibility for some but not all elements of the program (investment policy, or plan administration; or benefit design).

Some, but not all elements of the pension program may be negotiable and subject to collective bargaining. Bargaining on pensions may be separated from or integrated with bargaining on wages, salaries, other benefits, and working conditions.

During the last 15 years, there has been a strong trend of increased participation and responsibility sharing. The development of collective bargaining in the public sector has been an important factor behind this trend. The debasement of real pension expectations as a result of high inflation rates of the 1970s and early 1980s has intensified the public concern with pensions. Tax incentives have further promoted savings for retirement. New savings programs have developed and older ones have expanded.

A number of successful public sector plans in Ontario are of this model. There is significant minority representation of plan members in some of the decision-making bodies of HOOPP. The participation of members in the governance of OMERS is stronger. Most of the university pension plans involve members in some aspects of decision-making.

Although the Ontario Teachers' Federation has a long history of discussion and influence with the government on teachers' pensions, we believe that the relationship is not one of limited partnership with shared responsibility.

The Rowan report recommends that, even if the existing defined benefit pension deals continue for the teachers and the public servants, substantial minority representation of members on the investment boards should be instituted.

❒ Full Partnership and Joint Trusteeship

Under full partnership and joint trusteeship, the employer and employees share equally in the power and responsibility for the pension program. In partnership, employees and employer both decide on all major elements of the pension program and share equally in the pension program's rewards and in the responsibility for its financial health. Major pension program elements are formally discussed and can be bargained collectively or separately from wages and salaries, other benefits and working conditions.

In Canada, full partnership and joint trusteeship has characterized multi-employer programs in the construction industries and forest industries for many years. They have shown a good record of fiduciary responsibility, prudence and sound management.

A number of public sector pension programs in Canada fit the model of full partnership and joint trusteeship. The TTC pension program is the best known example in Ontario. Other examples in Canada of jointly trusteed plans include British Columbia Telephone's pension plan as well as multi-employer plans, such as those covering virtually all building trade unions, retail workers in the United Food and Commercial Workers Union and the International Woodworkers of America in Western Canada. Other Canadian pension plans in the public sector that have a great deal of employee participation/trusteeship include: the pension plans of the city of Saskatoon and the city of Winnipeg.

While full partnership and joint trusteeship are not often found in pension programs in the private sector, collective bargaining on pension matters is common. The trend is for increased emphasis on pensions in private sector negotiations.

SECTION IV

❒ Funding

❒ Private Sector

In Ontario the target for virtually all private sector defined benefit pension programs is full funding. The principal objective of full funding is to secure the pension obligations. Important secondary concerns are that pension costs should be identified and paid for as benefits are earned, and that costs should not be transferred unduly from present to future generations.

Since private sector institutions are mortal entities and do not have the ability to tax, they are required to have adequate accumulated assets to meet pension obligations. Pre-funding of benefits provides the assets. It is mandated by the PBA and monitored by the Pension Commission of Ontario.

In considering funding, private sector pension plans must distinguish between a "wind-up basis" and "going enterprise/concern basis" for reckoning pension liabilities. The "wind-up basis" concerns having sufficient assets to cover pension obligations outstanding for accrued service to the wind-up date. In order to ensure that a private institution has sufficient resources to discharge accumulated pension obligations if a wind-up situation develops, funding to cover estimated wind-up pension obligations is obligatory. If for any reason, the wind-up pension obligations are underfunded during the pension program's lifetime, then a short-term program for amortizing the funding shortfall is mandatory in Ontario.

Most private sector pension plans in Canada are valued as well on the basis of "going concerns". At the valuation date, the question is not only about the assets to discharge accumulated pension liabilities for service to date. It is whether in addition the future contributions and investment earnings will be sufficient to discharge the pension liabilities arising in the future, under the assumption that the entity will continue indefinitely into the future. If the answer is "no", the pension

program is underfunded and an amortization program over a period up to 15 years is usually instituted. If the fund is in surplus at this valuation, the disposition of that surplus becomes an issue.

A complicating factor in the funding of private sector pension programs arises from the practice of ad hoc inflation protection of pensions. If the inflation protection is contractual (even if not mandatory), the reckoning of the pension liabilities for purposes of determining the funding status will have to include the value of the indexation. However, when the inflation protection is ad hoc, (i.e., not contractual), it does not enter into the valuation. Even so, if a pension program has a long record and continuing policy of ad hoc indexation, it must make some provision to be able to fulfill the policy. A pension program that is just barely fully funded for its other contractual obligations may have difficulties in achieving its indexation goals.

In Ontario, private sector pension programs are permitted under the law to finance inflation protection undertakings on a "pay-go" or "partly funded" basis; but such practices for the private sector are strongly discouraged by the regulatory authorities and are regarded as unsound practice by the actuarial profession.

The pension regulatory authorities welcome larger surpluses in the funding of private sector pension funds. The income tax authorities prefer smaller surpluses, because the build-up of surpluses in pension funds reduces the tax collections. We encountered much concern that the new tax proposals may be too restrictive on the surpluses permitted for pension funds.

The controversies and litigation over the ownership of surpluses in pension programs seem to be discouraging surplus accumulation. This could be unfortunate in view of the prospect of mandatory indexation of defined benefit pensions.

❐ *Public Sector*

Funding for public sector plans is more complex than for the private sector, and appropriate answers are less apparent. Governments can be viewed as immortal for pension purposes and have the right to impose taxes to raise revenue to meet obligations.

It is not essential that public sector pension programs be funded. The issues then are good management, prudence, intergenerational fairness for taxpayers and members of the pension programs and enhanced security of the pension programs.

Retirement income programs for the general public in Canada are either totally unfunded (OAS/GIS) or partially funded (CPP/QPP). The recent changes in the CPP/QPP offer very clear messages to partially funded programs.

To maintain essentially the same benefits in the future, in the sense of pension replacement of income up to the average industrial wage, the combined contribution rates of employers and employees to the CPP will have to increase in a series of gradual steps over the next 25 years from 3.6 per cent of eligible earnings to 7.6 per cent of eligible earnings.

Except for the indexation, pension programs for teachers and public servants in Ontario, virtually all the public sector pension programs in Ontario aim to be fully funded for their contractual obligations. Full funding is sought on both a "windup basis" and on a "going enterprise/concern basis". Those which have a policy of attaining a considerable measure of ad hoc indexing, e.g., OMERS and TTC, though not on a contractual basis, typically aim for surpluses in their current funding, mainly to be able to discharge their indexation objectives.

Pension history shows that there has been a good deal of use of "pay-go" or "modified pay-go" (i.e., partially funded) pension programs for public servants and teachers in North America, particularly in the United States. The history does not show many sustained successes. It does show repeated difficulties and turmoil, both for the members of the pension plans and for the governments that have to cope with the problems. The documents we examined came down heavily in favour of substantial, if not complete, funding as a target for public sector plans in the United States. They also indicated a strong trend toward adopting such targets[1].

While a substantial element of funding is not essential to secure public sector pension programs, the view is widely held that it does help with the security of the programs. In contributory plans especially, a high level of funding, together with strong pension plans, ensures the promised benefits will be delivered by future governments. Funding also gives plan members an important perception of security. A strongly funded position assists in the management of pension programs.

We found from the enquiries we initiated that in Ontario the view is widely held that very unsatisfactory results have been produced by the separation of the adjustment funds from the basic pension programs for the teachers and public servants; and failure to adjust the contribution levels to better fund the indexed pension benefits. Many misunderstandings have arisen. Because of delays in dealing with the problems, these have intensified. The potential long-run increases in contribution rates will result in highly inequitable intergenerational transfers of the burdens of the pension programs. Problems may arise in provincial debt management in the future.

SECTION V

❐ *Investments*

Having regard for the recommendations that the teachers' and public servants' pension programs be transformed into diversified market portfolios, we have been very interested in what might be derived from such a change. Much Canadian experience exists from which to discern answers.

❐ *Experience of Other Pension Funds*

Virtually all the private sector pension programs in Canada and the majority of the public sector ones in Ontario hold their assets in diversified market portfolios. Most of them have a good record of investment returns much of the time - generally a better record than they would have had by holding only government bonds. OMERS, HOOPP, HYDRO, The TTC Pension Society and a number of university pension programs have been high on the league table of investment returns of institutional funds.

OMERS provides an important example in another respect. This is the changeover from a non-market portfolio of long-term government of Ontario debt instruments to an almost complete market portfolio - a changeover undertaken since 1976.

Because of the size of the assets and cash flows of the teachers' and public servants' pension funds in Ontario, our enquiries supported the Rowan report recommendation that the portfolio transformation be carried out gradually. Considering the absorptive capacity of the Canadian markets and the time required to develop policy and staff, we were advised that three to five years

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1 Thomas P. Bleakney, Retirement Systems for Public Employees. Published for the Pension Research Council by Richard D. Irwin, Inc., 1976; and Dan M. McGill (editor), Financing the Civil Service Retirement System: A Threat to Fiscal Integrity. Published for the Pension Research Council by Richard D. Irwin, Inc., 1979.

would be an appropriate phase-in period for reaching full market deployment of cash flow. We were also advised that the maturity dates of the existing non-market portfolio might be accelerated, so that its conversion to market instruments could be completed in less than the 25 years now required, given the maturity structure of the existing assets.

❑ *Importance of Investment Returns*

If a pension program is fully or substantially funded then the resources available to pay for benefits will depend greatly on the rate of investment earnings on the fund. Pension program costs are designed to be covered by contributions and investment earnings. For any given scale of benefits, contribution rates can be lower if long-term investment returns are high. Given a set of contribution rates, benefits can be larger if investment returns are higher.

In a mature, fully-funded, defined benefit plan, the cash flow from investment earnings will quickly outstrip the income from employee and employer contributions. Based on a given set of benefits from an established contribution rate, an average real rate of investment return of three and one-half per cent per year can improve the benefits by at least 10 per cent more than those that can be achieved with a three per cent average real rate of return, other things being unchanged. As another indication, 65 per cent of the cash flow of the TSF is from investment earnings and only 35 per cent from the combined current government and member contributions in 1987.

❑ *Choice of Targets for Investment Returns*

For the investment policy of pension programs, a choice exists between a risk-free, low-risk, moderate-risk or a high-risk investment portfolio within the limits set by the legislation and regulations for pension fund investments. Within these broad strategies, choices also exist about the kinds of risk assumed.

Generally speaking, the higher the risk accepted, the higher the target rate of investment returns from assets.

It is conventional wisdom that pension programs, and particularly public sector pension funds, because of their long future duration at any given time, can accept a low or moderate degree of risk in their investment targets rather than invest on a risk-free basis. The issue of what rates of 'interest' or 'discount' to use for valuing the pension benefits and determining the contribution rates is another matter.

In his advice to the Consultations, Keith Ambachtsheer indicated the importance of viewing pension program management from two aspects: the actuarial perspective; and the management of the investment resource. While the primary aim of investment resource management is to ensure there are enough resources to secure benefits, once the pension program is secure the potential exists to use the assets to yield a high investment return. If the high investment choice is taken, it is important to establish beforehand how the risks and rewards are to be allocated.

We examined three pieces of advice about risk-free rates of interest or discount appropriate to use in Ontario at this time. The Coward report indicates such a rate as two per cent real. We commissioned a report from Professor James Pesando; he indicates such a rate as three per cent real. Keith Ambachtsheer's recent "Letter" indicates such a rate as being in the range of two and a half to three and a half per cent real. The advice we received from investment counsellors and managers on the subject of investment returns pension funds might expect from low and moderate risk diversified market portfolios is consistent with the Ambachtsheer judgment.

We received several pieces of advice to the effect that a realistic long-run expectation of a diversified market portfolio for a large pension fund with low risk would be in the range of three to three and a half per cent real, closer to the high than the low end of the range; similarly, the same expecation applies for a moderate risk portfolio in the three and a half to four per cent real range. Using the MYW (now Scotia McLeod) indexes of investment returns for a portfolio of 50 per cent TSE 300, 25 per cent long bonds and 25 per cent mortgages, the average compound real rate of return during the last 30 years is 3.91 per cent per annum and during the last 25 years is 3.36 per cent per annum. According to the Report on Canadian Economic Statistics 1924 - 1986 from the Canadian Institute of Actuaries, a comparable portfolio during the 25 year period 1962 - 1987 would have had a real compound rate of return of 3.02 per cent.

We were warned repeatedly that a higher reward, higher risk market portfolio, even with the stabilizing characteristics arising from diversification, will experience variability and volatility in returns and in market value. Some of these will be transitory and can be coped with by well-established averaging techniques and reserve management. Some might require corrective action over a period of several years.

To put some dimension on the risks arising from volatility, we commissioned a report from Keith Ambachtsheer which included an analysis of how severe the worst "bad news" of investment performance of a diversified market based pension fund might be; and how favourable the best "good news" might be in light of market history of the last 60 years. Together with some estimates from Peter Hirst, an advisor to the Consultations, a possible course of correction of such wide swings was translated into increases or decreases of contribution rates over several years. Even in the worst case, the increased contribution rates seem to us to be bearable. In other cases, which includes some use of averaging and some investment variation reserving in good times - it appears that pension funds can cope with considerable variations without endangering the security of the pension obligations or undertaking drastic corrective actions.

We were warned repeatedly not to extrapolate into the long run future the exceptionally high real rates of investment earnings of most pension plans in recent years. Many persons spoke of the last few years having been the most favourable ones in this century for high real returns on fixed income securities. Even after allowance for the October 1987 fall in stock prices, the record of the last few years is one of the longest bull markets and largest increases in average stock prices in a century.

We were also warned that, for very large pension funds such as the teachers' and the public servants' funds, it is difficult to "do better than the market" over the long term from a large diversified portfolio. Caution is called for concerning expectations of persistent potential high investment returns.

SECTION VI

❒ *Indexation*

Inflation protection is in itself not an issue but the concern is instead in the degree, pace and form of providing inflation protection adjustments. Although there are few Canadian employment based pension plans with contractual inflation protection, most plans have made, and continue to make, some form of "ad hoc" inflation adjustment. If Canadian inflation rates were to follow recent history, even without mandated inflation protection, it seems reasonable that plans committed to providing adequate pension income on retirement would continue to provide some substantial measure of inflation protection.

High, variable and uncertain inflation in Canada during the 1970s and early 1980s imposed severe problems for pension programs. Past practice in most public and private sector pension plans has been to offset the effects of inflation on pensioners through ad hoc, non-contractual inflation adjustments. Contractual inflation protection in Canada has mainly been provided in public sector

pension plans. Those pension plans are the federal public service, Ontario's teachers' and public servants' plans and some other provincial government plans. At least two major private sector employers provide contractual inflation protection, and contractual undertakings are increasingly entering into collective agreements in the private and public sectors, usually for partial indexing.

It is clear that future inflation protection is highly controversial, specifically in the area of appropriate levels and at what pace to apply the protection. The government's response to the Friedland Task Force report can have profound effects on both private and public sector pension plans in Ontario. The inflation protection issue is very pertinent to the current contractual indexation arrangements for Ontario's teachers and public servants.

In our Consultations we reviewed the Friedland Task Force report and research. Since that report and associated research is so thorough we need only to review and comment on the main lessons it provides for the teachers' and public servants' pension programs. This section also reports on other analytical and policy views we encountered in our research and discussion.

❒ *The Winners and Losers in a Defined Benefit Program not Adjusted for Inflation*

As a broad generalization, an increase in the rate of inflation will, sooner or later, be accompanied by an increase in nominal interest rates, the market price of equities, and the prices of property. A decrease in the rate of inflation will be accompanied by decreases in these areas.

The degree and timing of the correlation of changes in inflation rates and nominal interest rates, the market price of equities, and the prices of property are quite variable. As an example, for periods of several years there can be a gap between the increase in the CPI and the nominal interest rates of government of Canada bonds.

For a non-indexed defined benefit plan based on an average of best final years salary, any rate of inflation above zero leads to a deterioration of the real value of benefits over time. Calculating the initial pension on an average of final earnings provides considerable, but not perfect, protection against inflation to the "start-up" pension. The higher the rate of inflation, the less a final earnings average can protect the "start-up" pension.

The consequence of inflation is such that the real income of pensioners who do not have indexation of their pensions decreases over time. The higher the degree of inflation, the more severe will be the deterioration of the real value of the pension benefits.

Pensioners are the obvious losers from defined benefit pensions that are not protected against inflation, either contractually or in an ad hoc fashion. Their losses can be severe. A pension of $1000 per month at age 65 will have been reduced in real value to $675 per month for a surviving pensioner at age 75, if inflation averages four per cent per annum over those 10 years.

The question remains, who gains from inflation, and how? Under an non-indexed plan, the gains arise from higher nominal investment earnings which arise from the inflation providing surpluses in the pension fund or reductions in the contributions made by the employer. Inflation gains arise through higher interest rates, dividends and capital gains and increasing property values. Depending on the pension deal, private sector pension programs tend to share the gains among customers, suppliers, active workers and shareholders.

Because of the imperfect matching of inflation rates and nominal investment return rates, in any given period the pension fund gains may be more or less than the pensioners' losses. But the qualitative nature of the transfer gains is certainly from pensioners to and through employers to other persons. In most situations, the transfer of inflation gains will show up partly as pension fund surpluses during some time.

Inflation protection payments made to pensioners reverse the transfer effects of inflation. The payments to pensioners would be real income gains, or at the minimum, reductions of real income declines. In the private sector example, such payments to pensioners will be made at some cost to the customers, suppliers, workers and shareholders. If the inflation offsets made to pensioners do not completely cover the effects of inflation, then pensioners are still the net losers from the combination of inflation and partial inflation offsets. Similarly, if the offsets are partial, some net gains to the customers, suppliers, workers, and shareholders will persist.

If a pension fund had been fully funded at zero rate of inflation, and if the inflation rate was fully reflected in nominal rates of returns on investments, on average, over a number of years, then it may be possible to fully offset inflation effects on pensioners with neither a net gain nor loss to pension plan principals. The Coward report reflects this message. The question then becomes one of the exact matching of variations in inflation and in nominal investment returns.

Professor Pesando and others have argued that the real rate of investment returns on large mixed market portfolios does not remain constant as inflation increases, but rather declines somewhat. Put another way, this argument is that nominal interest rates do not increase as much as inflation increases. This issue is moot. However, even if there is a modest decline in the real rate of investment return as inflation increases, most of the burden of fully indexing pension benefits could be met through limited real transfers. The Coward report's assumptions about inflation-proofing pension programs would be almost fully met.

The same argument applies to a public sector pension program, except that the gains would be shared by taxpayers, instead of customers, suppliers, shareholders, etc.

❐ *The Cost of Indexing Pension Benefits*

Much has been said about the cost of indexing pension benefits. In the literature we have reviewed, estimates such as the following have been made. Using a final average, defined benefit, unindexed pension plan as a model, consider the program costs 12 per cent of earnings. A 60 per cent CPI formula indexing would add an additional cost equal to three per cent of earnings. A 100 per cent of CPI, capped at eight per cent with a banking carry forward, would add an additional 5.5 per cent of earnings to the cost of the unindexed pension plan.

If in both the labour market and public policy, the real alternatives were a choice between an unindexed pension and a substantially indexed pension, the comparisons made above would be the correct way to consider the cost of pension indexing. However, modern history of Canada and the industrial world indicate that the choice is not an absolute "not indexing at all" or "fully indexing". Though not mandated by statute or pension contracts, most Canadian private and public sector pension programs have, and continue to provide, a substantial degree of ad hoc indexing.

The fundamental issue, therefore, is whether a basic plan, with its benefits and indexing aim, can be funded with a combination of contribution rates and prospective investment earnings. If the answer is that it cannot, then either the basic benefits, indexing aim, contribution rates or investment earnings must be adjusted. If the pension program is adequately funded at a zero rate of inflation, most of the real cost of the inflation protection aim can be met without increased real burdens on contributors.

❐ *Some Details on Indexation*

Inflation protection raises different issues for defined benefit and defined contribution, or hybrid pension programs.

- **Defined Benefit**

Most of the pre-retirement inflation protection is provided by basing the pension on the final years' average salary. Generally speaking, using the actual final year offers more inflation protection than a final three-year average or final five-year average, etcetera. The majority of defined benefit pension programs are based on final three-year or final five-year averages. Usually, the farther away the calculation basis is from the contributor's final year of salary, the greater the potential impact of inflation in reducing the replacement ratio of the pension benefit at the time of retirement.

For pensioners, the bulk of inflation protection is met through ad hoc increases which are usually geared to and partially cover increases in the CPI. Ad hoc coverage appears to have varied between 30 per cent and 60 per cent of the CPI. A number of large pension programs with a practice of providing ad hoc increases reported that their target for inflation protection for pensioners is around 60 per cent of the CPI.

Ad hoc indexation is not contractual and does not enter into the valuation of pension plan liabilities, except that once a particular set of ad hoc payments is granted that amount is a charge against the fund. Typically, pension programs which regularly practise ad hoc indexing do consider these costs in their planning and management. On average, such programs have contribution rates and investment earnings which are deliberately aimed higher than what are needed to meet their unindexed pension obligations. On average, the program builds surpluses which can be used to meet ad hoc indexing. This is an important requirement when judging the financial health of a pension program.

With mandated inflation protection, the contractual indexation of liabilities will have to be considered in the valuation of pension programs. If the mandated inflation protection covers only future service, the impacts on pension programs will be small at the beginning and become a significant cost factor more gradually. If contractual indexing is applied retroactively the impacts will be both large and immediate. It would appear that pension programs that have planned for ad hoc indexing through deliberately aiming for larger contribution rates, surpluses and investment earnings to finance ad hoc indexing, will find little change in the overall financial health of their pension program. Those that do not follow such an approach would find their pension programs would have substantial unfunded liabilities under fully retroactive contractual indexing.

The Friedland report proposals are recommendations for a minimum level of indexation and we recognise that the report encourages indexing at levels higher than the minimum.

- **Defined contribution and hybrid pension programs**

For inflation protection, defined contribution and hybrid pension plans are less problematic for employers and more uncertain for employees. In a defined contribution arrangement the burden of providing for inflation protection after retirement rests on the pensioner.

A defined contribution plan or a hybrid plan with a defined contribution component is essentially a fund which is accumulated in the name of each participant. The fund size depends upon contributions made to it and the fund's investment performance. The size of the fund is used to purchase an annuity contract at, or just prior to, retirement. Annuities are available that will perform an inflation protection function. The person retiring would make trade-offs between the basic benefits and the inflation protection he/she wants, within the framework of the amount of money available to purchase the package. Some pension plans are arranged so that the participant does not have his/her pension contract dependent on the value of the fund on a particular day, but rather depends on an average over some longer period.

In a mixed pension program, such as is operated by several Ontario universities, a basic minimum pension is guaranteed, with supplements added depending on the investment fund's performance. This approach essentially provides an excess earnings form of inflation protection. The Friedland report indicates that the excess earnings approach to inflation protection no longer commands general support and outlines why this is so.

SECTION VII

❒ *Contribution Rates and Their Determinants*

❒ *Relationship of Contribution Rates and Investment Targets*

There are several schools of thought about the appropriate rate of 'interest' or 'return' or 'discount' to use for valuing and costing pension programs on the one hand and setting investment targets on the other.

One school of thought emphasizes caution in all respects, counselling that a risk-free rate of return should determine both contributions and valuation and the investment aim. This approach tends to lead to relatively high cost pension programs, but with little investment risk and rather limited possibilities of generating surpluses or unfunded liabilities.

Another school of thought emphasizes caution in setting the interest rate for determining contribution rates and valuations, but accepts modest risks and variability in investment policy in the pursuit of a higher investment return. Such an approach would lead to contribution rates which will tend to be high in relation to the normal benefits to be received from the program. Investment performance will vary over time between surplus and unfunded liability positions, ***but the program will tend to generate more surpluses than deficits.*** The long-run average of surpluses could be distributed in various ways.

A third school of thought counsels a "realistic" approach to setting contribution rates, valuing, and investment aim, involving moderate risks on both costs and investment aims. Normal contribution rates will be lower than under the more conservative costing approaches. The fund will vary from surplus to deficit and back over short cycles, tending to average over time. Sometimes the deficits may reach figures large enough that significant adjustment programs will have to be introduced to keep the plan on a sound basis. If so, it is likely that in the long run these adjustment programs could be reversed.

A fourth school of thought is even less conservative. It would recommend adopting a moderate risk rate of 'interest' or 'discount' for costing and valuing the pension programs and acceptance of even higher risks and potential for higher investment rewards. Normal contribution rates would be lower than the other approaches noted and would yield even higher average surpluses over the lifetime of the pension program. This approach would also introduce substantial investment performance volatility and require a larger and more frequent adjustment program than under the third school of thought.

❒ *Other Actuarial Assumptions*

We encountered some controversy over a number of the other actuarial assumptions and models that affect contribution rates.

The first of these is about the use of unit credit or entry age normal bases for determining contribution rates. For our purposes we note that unit credit bases are widely used in the private sector. Depending on the age structure of the membership of a plan, in the short run, the unit credit method may lead to lower contribution rates than the entry age normal method; but may lead to higher contribution rates later.

The second of these concern the level and relationship between the nominal rates of interest, the rate of increase in nominal salaries and the rate of inflation. For a fully-indexed, defined benefit, final average plan:

- the larger the "gap" between the rate of salary increases and the rate of interest, the smaller the contribution rates required, other factors being unchanged;
- the larger the excess of nominal interest rate over the inflation rate, the smaller the contribution rate required, other factors being unchanged.

While the long-run trends of these economic variables are related, a great deal of variation and conflicting interpretations exists among them. Thus contribution rates are at best somewhat rough and ready forecasts which must be monitored and adjusted in the light of experience.

CHAPTER 5

The Issues and Strategies

Introduction

In order to work out reform of the pension programs for teachers and for public servants in Ontario, nine sets of issues have to be resolved. These relate to:

- Trusts and Trusteeship
- Relationship to Collective Bargaining
- Process of Monitoring and Change
- Self-Containedness, Self-Sustainedness of Programs
- Market Investment Portfolio
- Basis for Contribution Rates
- Basic and Inflation-Protected Benefits
- Past Service Unfunded Liabilities
- Minimum Requirements

While all of these sets of issues apply to both the teachers' and public servants' programs they can be resolved differently. Similarly, other issues will have to be considered which are specific to each of the programs.

In this chapter each of the nine sets of issues is developed in detail and presented mainly as a set of questions. Some answers are suggested and comments are offered on the issues. Some impressions of attitudes of representatives of teachers and public servants are also noted.

SECTION I

❐ *Trusts and Trusteeship*

Are the pension programs to become joint trusts of the participants and the government, at arm's length from government, providing retirement income and related benefits on a self-contained, self-sustaining basis? Or is the government to continue to be the sponsor and sole trustee, albeit with somewhat increased roles for participants to offer advice, express investment interests, carry out educational programs, and share administration? Alternatively, is some intermediate structure of participation to emerge?

If the choice is for joint trusts of the participants and government, is the responsibility of the trusts to be fully and equally shared? If not, how is it to be shared? How will the responsibility of the participants be exercised through some representative bodies which would have to obtain and retain their mandates from their constituencies? Would the responsibility of the government be exercised by persons representative of the government as trustee rather than employer? How would impasses be resolved if the joint trust is equally shared between participants and government trustees?

If the choice is made to have the government as sponsor and trustee, what is of consequence and what arrangements are to be implemented to increase the roles for participants and their representative bodies? - Would it be a high level periodic pension advisory review by representatives of the principals, perhaps following each triennial valuation? - Would there be an annual review of all or selected aspects of the pension programs: in particular, benefits, investment performance, contributions? Would participants be members of an investment advisory board? What roles could be taken by the existing pension advisory and regulatory boards and commissions?

❐ *Comments*

Pension programs organized through employers are the most important personal asset next to equity in home ownership for Ontario's teachers and public servants. They are critical to individual responsibility for saving and lifetime management of income.

Pension programs should reflect the needs and preferences of workers regarding their pay and benefits and investment opportunities as well as demographic changes. They should also relate to the needs and preferences of employers, e.g. labour market competitiveness, costs and employment standards.

Pensions are complex. Most individuals cannot inform themselves effectively on pension matters on their own. Representative organizations (federations, unions, associations) are important agencies for pooling knowledge, determining trade-offs, and informing individuals and employers on the pension interests of workers. They are important agents in support of worker interests. Representative organizations have become much more proficient in Canada over the last 50 years. They have acquired much greater expertise in pensions and related benefit matters that are of concern to their members.

It is generally agreed that the status quo relationships between the participants and their representatives and the government regarding the teachers' and public servants' pension programs in Ontario are unsatisfactory. The structures have not encouraged responsible behaviour. The facts of the pension programs are in dispute. The mechanisms for the timely development of a consensus among the interested parties have not worked effectively. There is no mechanism to force timely reconciliation of the benefit - investment - contribution relationships.

Full and equal partnership of participants and the government in a joint trust would enhance the responsibility for pensions and related benefits. Subject to agreement on major policies by the negotiating principals, the joint trustee boards could determine the health of pension programs and require timely action to maintain their overall health. Responsibility could be exercised by the joint trustee board to improve the factual basis and the analysis of the programs, to improve the functions of education and information and to determine and monitor the investment performances.

If the pension programs are to be self-contained and self-sustaining, with equal sharing of the risks and rewards by participants and the government, full and equal sharing in the membership and responsibility of the trustee board appears to be reasonable. Token representation is unacceptable to unions and representative bodies. In that case, most of them would rather have none. The Rowan report recommends a substantial minority representation for the pensions investment boards under the existing teachers' and public servants' defined benefit deals. This might be considered if the new deals involving full sharing of risks, rewards and responsibilities cannot be achieved, even if the major share of the risks continue to fall on the government as employer.

Joint trusteeship between the government and the representatives of the participants will increase the power of the representative organizations (federations, unions, associations). Canadian evidence indicates that when such representatives have real power and responsibility in pension matters, their behaviour is prudent and responsible. The fiduciary responsibility to the workers and pensioners is of high quality and is exercised equitably among the constituencies.

There already exists an alternative of sole government sponsorship and trusteeship, together with some improvement in the advisory arrangements. A new approach such as joint trusteeship appears so attractive, however, that it should be given priority in the imminent negotiations.

SECTION II

❐ *Relationship to Collective Bargaining*

The issue of collective bargaining on pension issues arises regardless of the trust and trusteeship. The relationships would be different if full and equal partnership and joint trusteeship are developed rather than substantial minority representation on a board of trustees merely for consideration of selected pension issues. The relationship would be different also if the provincial government continued to be the sole sponsor and trustee with improved consultative arrangements. Collective bargaining or some comparable form of negotiations on a wide range of pension matters could arise under every form of trusteeship.

If pensions become an element in collective bargaining, how are they to be related to other elements of bargaining for teachers or for the public service, but divided among a number of unions and associations? - What about those public servants who are not unionized? What range of pension issues would be subject to collective bargaining - benefits - contribution rates and their distribution - investment policy and funding target? - What about the adjustment of deficits and surpluses? If there is substantial or equal representation of the participants on the board of trustees, what is to be the relationship between pension issues that are a part of collective bargaining, and those which are the responsibility of the board of trustees? If, alternatively, the government is the sole sponsor and trustee, but participants are active in advisory roles, how will the advisory role and the collective bargaining on pension matters be kept in harmony?

❐ *Comments*

Collective bargaining for teachers and public servants already includes a number of short-term and long-term issues. Short-term, such as the pay scale for next year - long-term, such as seniority and job security matters. Pensions raise many short-run and long-run issues - more of the latter than the former. If pensions are bargained, the unions, federations and associations will have to develop both the expertise and the exercise of judgment to deal with the enhanced list of long term issues.

Having regard for the strength and maturity of the organizations representing teachers and public servants in Ontario and the importance of pension issues to employees, it is hard to see how, or why, pension matters can be excluded from negotiation and bargaining in the future.

The fundamental nature of a pension deal, such as whether the design is defined benefit, defined contribution or hybrid, or whether there is to be explicit sharing of risks and rewards, cannot be changed from year to year. A goodly measure of tuning can take place in the short run, but fundamental changes have to be more deliberate and long term.

If pensions are to be an element in collective bargaining under a regime of equal joint trusteeship of a pension program, then a sufficient degree of compatibility must be achieved between the fiduciary role of the trustees and the terms of collective agreements. If pension benefits are to be increased at the collective bargaining table, trustees must be able to obtain the resources required to realize the improvement. The union, federation or association must have sufficient confidence in the trusteeship so that it can deliver the contributions necessary to meet the pension obligations.

If collective bargaining on pension matters takes place under any of the trusteeship arrangements other than full, equal joint trusteeship, the compatibility of the collective bargaining and the other arrangements for shared participation may be feasible but is likely to operate in an awkward and unsatisfactory manner. The unions, associations or federations would find it difficult to keep their advisory roles and their collective bargaining roles in harmony. The government might find it difficult to engage in frank discussions lest it undermine its bargaining position. Full partnership and joint trusteeship would impose a disciplinary framework not only on the collective bargaining on pension matters, but also on advisory and administrative roles of the participants.

Serious but different problems may arise in working out shared trusteeship together with collective bargaining on pension matters for the teachers and for the public servants.

For the teachers, their employers are the local school boards with whom they bargain salaries, non-pension benefits, and working conditions. Pensions are determined at the provincial level after discussions between the OTF and the government. This split arrangement could be continued and reconciled with any of the pension trusteeship alternatives. However, many interested parties have argued that pensions have to be brought more closely into a total compensation framework for teachers. To make progress in this direction, new institutional structures would have to be developed to link the various elements of teachers' compensation.

It is our impression that the teachers' organizations do not seek a major change in the structure for bargaining their pension interest. However, they would welcome a more explicit right to bargain and more formal arrangements for bargaining.

For the public servants, the problems arise from the multiplicity of unions and from the substantial non-unionized sector. First, the sharing of union representation on a joint trustees board will have to be worked out. Second, if a unified pension plan is continued for public servants, representation will have to be shared with the non-unionized participants. Third, if each public sector union engages in collective bargaining and the negotiation of pension fund issues, sufficient compatibility will have to be achieved in the collective bargaining itself and between the collective agreements and the trustees' responsibilities. All of these issues can be resolved, but a considerable measure of trust, goodwill and cooperation will be required among the various representative bodies and among them and the government. The union/non-union issues might be more readily resolved if the public servants' pension programs were to be split into two or three separate programs. One program might be designed to serve the needs of the unionized sectors; the other the professional, administrative and managerial groups.

OPSEU, CUPE and OLBEU indicated to us that they want to be able to bargain collectively on pension matters, design the plan through negotiations and amend it without changing legislation.

SECTION III

❒ *Process of Monitoring and Change*

How is the misinformation, mistrust and scepticism about the financial status and prospects of the teachers' and public servants' pension programs to be overcome?

Since it is inevitable that many aspects of the pension program will have to be modified in the light of experience and changing needs and opportunities, what is to be the process for effective monitoring of the programs and determination of the change?

❒ *Comments*

Since such large changes are being proposed for the teachers' and public servants' pension programs in Ontario there will be an unusually large degree of uncertainty. The shifts proposed are to make the programs arm's length to the government, to transform the funds into a market portfolio, and to make major changes in funding targets. Each proposal is of major importance and impact. Taken together they are massive. Unusual care in monitoring and analyzing the new pension performance will be required.

It seems likely that more progress can be made on the new deals if they are struck in broad general terms, together with a start-up deal that appears both fair and deliverable, rather than a deal in which every detail is tightly specified at the outset. Since the details will have to be settled sometime, it may be even more important than usual to have a strong process for monitoring the performance and determining the necessary or desirable changes to the initial deal.

We believe that the majority of the organizations representing the TSF/TSAF and PSSF/PSSAF plan participants are not satisfied with the existing programs for monitoring and changing the pension programs. The consensus is that improvement is strongly desired.

Proponents of continued modified "pay-go" financing expressed dissatisfaction with the existing review processes and recommended strong mandatory reviews of such financing at least every five years.

SECTION IV

❒ *Self Containedness, Self-Sustainedness of Programs*

Is it intended to have the pension programs self-sustaining? In other words, are normal contribution rates plus reasonably attainable investment earnings intended to be sufficient to meet the pension and related obligations, without large unexpected crises resulting in benefit curtailment or contribution increases? Is it intended that the assets of the fund, their earning power and future contractual contributions will provide the security of the pension and related obligations? Since short-term variations in actuarial and investment experience are a normal part of the pension milieu, is it the intention that such variations can usually be dealt with by the management of the pension program itself?

Are the pension programs intended to have the attractive features of an assured defined benefit program with a high level of benefits, fully indexed, with moderate normal contribution rates, combined with sharing risks/rewards of performance deviations from intentions? Is it intended to have a hybrid design rather than a pure defined benefit program, i.e., one in which the risks/rewards are shared equally by the participants and the government?

Is the aim the full funding of the pension programs and if so, when and how? If the aim is not full funding, what is to be the funding aim? How is it be attained and when? How would it relate to collective bargaining? Can a funding target be approached gradually, by an amortization program or a scheduled gradual set of increases in contribution rates, or both?

Is the funding aim for a pension program to be considered on a wind-up basis or is it to be on a "going enterprise" basis or both? In other words, is it the aim of the fund to pay all accumulated pension obligations if the program was terminated? Does the fund aim to pay all accumulated pension obligations on a continuing basis? Beyond this, does the fund also aim at paying all future service obligations, having regard for future pension contributions and investment earnings?

Whatever the funding target may be, variations in economic conditions and actuarial experience over periods of three to five years will generate swings in the surplus and deficit valuations of pension programs. Can such swings usually be balanced out over the longer run of pension programs? If corrective action is required, by whom and by what means are the adjustments to be made? Should they be for surplus positions or for deficit positions? Is the sharing in adjustment intended to be symmetrical for surpluses and for deficits? What about longer run trends towards surpluses, or toward deficits? Are the designs of the programs intended to produce a trend of surpluses or of deficits? What bearing do the regulatory authorities and the taxing authorities have on the size and disposition of surpluses and deficits? If a pension program has a policy of ad hoc indexing, does this influence the design with respect to trends of surpluses?

For the Ontario teachers' and public servants' pension programs, are the government guarantees to cease?

❐ *Comments*

There is a great deal of merit in putting the teachers' and public servants' pension programs on self-contained, self-sustaining bases. With the assets and investment returns from a modest risk market portfolio, it should be possible to have a good set of benefits paid for from a reasonable set of contribution rates.

A full-funding target is preferable to a partial funding target. However, the target may be approached gradually by some combination of policies, such as:

- achieving investment returns somewhat higher than assumed for determining contribution rates, thus generating increments of surplus over the longer run which can be applied to the funding target;
- using an amortization schedule of abnormal contributions;
- raising contribution rates gradually on an agreed schedule.

The funding targets of greatest relevance to these funds is on a "going enterprise" basis, because of the life expectancy of governments. But if the programs are to be self-contained and self-sustaining, a secondary funding target should be on a wind up basis.

It would be more prudent to design the programs with a modest long-run trend toward surpluses than a trend toward deficits. The surpluses would be larger in 'good' times than in bad' times; 'bad news' could even give rise to modest deficits. The security of the program would be improved by a design aimed at moderate long run average surplus. The ability to cope with oscillations would be thereby improved. The programs would have some built-in "room for manoeuvre" to make long run improvements in benefits or reductions in contribution rates or to cope with adverse demographic experiences.

The contribution rates could be divided 50/50 between the participants and the government, or on some other agreed ratio. Any long-run accumulated surplus, as distinct from transitory surpluses and deficits, could also be shared on an agreed ratio, which need not be the same as the division of the contribution rates. A 50/50 deal all round would be the simplest to understand and administer, but that might not be acceptable to the negotiating principals.

Provided that the programs are set up on the bases described above, a government guarantee would no longer be required. If government guarantees were to continue, it might be difficult for the government to enter into a full partnership in sharing responsibility for all the fundamental elements of pension programs. It would face all the consequences of adverse performance but would not have a comparable voice in the decision-making process or share in the rewards.

Would the guarantee have to be continued with respect to pension rights earned to date even if it was terminated for future service liabilities? This would not be necessary if the past service liabilities were fully funded.

The largest factor in variations in the overall performance would arise from variations in investment returns. Some investment reserve management policy or actuarial averaging, or some combination of these approaches, are accepted practice for coping with such variations in private sector pension funds and some public sector plans. In the extreme, special amortization programs for unfunded liabilities may also be used. Similar approaches can be used for public sector programs. They are already in use by a number of other public sector pension programs in Ontario.

If, despite its unattractive features, a partial rather than a full-funding target for indexing or a merged program is chosen, that target must be definite and a firm process must be put in place to attain it. An adaptation of the teachers' and public servants' plans of the schedule and processes recently introduced to strengthen the funding of the CPP could be considered. Under the revised CPP program minimum targets are set for the fund, and these are to relate the scheduled increases in contribution rates on an estimated pay-go track to be determined by the federal government Actuary. A monitoring and adjustment process is established, as well as a mechanism to break deadlocks in case of disagreement among the principals.

❒ Our Interpretation of the Views of Employee Representatives

- The OTF did not express an official point of view, either in favour of, or against, full funding of the inflation adjustment benefit. The OSSTF, however, is strongly opposed to merging the teachers' basic plan with the TSAF until the TSAF fully matures. The OTF wants the government to continue to guarantee the defined benefit pension program.
- While OPSEU, CUPE AND OLBEU did not express an opinion about fully funding the inflation adjustment benefit, they and the OPPA support the amalgamation of the PSSF and the PSSAF.
- The OPPA prefers that the PSSAF continues with a modified "pay-go" funding basis, combined with an immediate and scheduled gradual increase in contribution rates for both plan participants and the government. The OPPA believes that under a diversified investment strategy, together with the contribution increase, positive cash flows for the inflation adjustment benefit are possible well into the 21st century. They think that with a successful diversified investment program, the inflation adjustment benefit may be able to move to full funding over time.
- The OFL does not believe that any public policy is served by prohibiting "pay-go" financing in the public sector. Indeed, they believe that this approach may provide both greater stability and predictability to contribution rates than pre-funding driven by variations in investment yields.

SECTION V

❒ Market Investment Portfolio

Is the investment of the pension funds to be market or non-market? If market, may investment be in the whole range of portfolio instruments permitted by the regulatory and taxation authorities?

If market, for some investments at least, would there be merit in investment in a market index through an intermediary, rather than the actual acquisition and management of all the procedures involved in running a portfolio directly? Would it be better to have diversified market portfolios run for the program by outside investment managers?

If a non-market portfolio, how are the investment returns to be credited to the fund to be determined? - As in Ontario at present? - Or as proposed by the legislation which has been introduced but not passed by the federal government for the federal public service? - Or by some other market benchmarks?

Will the "leanness" of the Canadian market for equities be a severe limitation on achieving desirable diversification and earnings opportunities of large Canadian market-invested pension funds such as those of the teachers and public servants may become? Would an increase in the permitted share of investment in foreign markets be desirable from the point of view of those funds?

Is the investment target of the pension funds to be a high, medium or low long-run average rate of returns; and accordingly to accept high, medium or low risk? How is the investment target to be related to the 'rate of interest' or 'rate of discount' for the costing and valuing of pension programs?

Who would gain and when would the gains appear from a strategy of pursuing a high long-run real rate of return from investment of the pension funds? Bearing in mind that such a policy would involve oscillation between gains and losses, even if the long-run trend was gain, how would the gains and losses be shared? Equally, or on some other agreed formula? On what basis should the decision be made?

Will the teachers' and public servants' pension programs have to file statements of investment objectives with the Pension Commission of Ontario in line with the requirements for all other public and private sector pension programs? Will the Pension Commission of Ontario exercise regulatory authority over the investment policy? Will the federal tax authorities and the provincial tax authorities also exercise regulatory authority over certain aspects of the investment policy and performance?

Could and should the pension programs of teachers and public servants consider social or ethical objectives in determining their investment policies? What would be necessary if they so desired?

❒ Comments

The case made by the Rowan report for transformation of the two pension plans to market portfolios is fundamentally sound.

From the point of view of the pension programs, the long-run prospect from a diversified market portfolio is a higher real rate of return than that which might be expected from what is essentially a single-instrument government bond portfolio. The risk need not be large. The volatility could be managed, just as hundreds of market-based private and public pension plans in Canada manage volatility now.

For the province, the cash requirements which are now met from the teachers' and public servants' pensions would have to be met out of the market. Also, gradually the non-market liabilities of the

two programs would have to be replaced by market issues by the province. The impact of these changes for the province's net borrowing requirements is discussed in the Rowan report. However, the province would benefit from having increased flexibility in its debt management operations.

While the transformation of the teachers' and public servants' pension programs to a diversified market portfolio would add more to the supply capacity of the equity than the fixed income markets, it should broaden both. The fixed income sectors of the capital market are already more mature than the equity sectors. Thus, the province of Ontario, with a top credit rating, should find little or no increase in the yield curves it faces as it substitutes market for non-market borrowing.

Provided that the transformation from non-market to market portfolios is phased in over a reasonable period of time (say, three to five years for the cash flow and as debentures mature for the existing non-market portfolio), the capital markets should not be shocked by the infusion of new market capital. Indeed, as a long run matter, Canadian capital markets should be strengthened by the transformation, as the Rowan report concludes.

From the narrow viewpoint of the interests of pension plan members, an increase in the allowable share of investments in foreign markets would permit wider diversification and provide opportunities for improved investment earnings. However, broader issues of Canadian social and economic policy must also be considered.

From the point of view of the participants in the pension programs, the transformation should enhance their feelings of independence, their sense of participation in the real economic activity of Canada and, to the degree that their pension investment is international, their involvement in the real economic activity of the world.

As to risk/reward strategy in a market portfolio, the participants and the government should be able to agree on investment strategies - low, moderate or high. What is important is that they know the consequences of the choice and build in processes and policies to deal with the consequences in the context of a pension program. Our preference would be for a moderate risk/reward strategy, with the risks and the rewards being shared on an agreed basis between the government and the participants. A moderate risk/reward strategy will yield higher average rates of investment returns than a low risk/reward strategy, and in the long run yield better pension benefits for the contributions or lower contribution rates for the benefits. Because of their long life and strong cash flows pension funds can tolerate moderate risks. Diversification can reduce the risk aspect for large funds.

A moderate risk/reward strategy will involve having a significant proportion of the investment portfolios in instruments other than fixed income.

Serious consideration should be given to having part of the market portfolio in the form of bond funds, which are based on bond market indexes, and in equity funds which are also based on equity market indexes. They may provide better yields than purchasing the instruments because of transaction cost savings.

If indexed bonds or mortgages become more generally available in Canada, they may be particularly attractive to pension programs, especially those with indexed pensions.

❐ Our Interpretation of the Views of Employee Representatives Regarding Market Investments

The OTF, OPSEU, OPPA, CUPE, OLBEU, OSSTF and OFL are all strongly in favour of investing these pension funds in the market. The majority of these bodies fully expect plan participants to share equally in any financial rewards arising from a diversified investment strategy. It is not clear to us, however, whether these organizations would be prepared to share in coping with any potential short-term investment downsides. All of the employee representative organizations have high expectations about the level of investment returns possible from a diversified investment program.

The following are specific investment views:

- Social Investments - The OTF would like TSF/TSAF investment policies to be limited to ensuring that the assets and benefits are secure and that financial returns are the best possible, within the bounds of prudent financial management.
- The OFL, OPSEU, CUPE and OLBEU are strongly in favour of permitting pension plans to invest in specified social objectives.
- The OFL, OPSEU, CUPE and OLBEU want the current 10 per cent federal income tax limitation on foreign investment of pension funds to be maintained. The OFL would agree to lowering the current foreign investment ceiling, or even to barring foreign investments.

SECTION VI

❐ *Basis for Contribution Rates*

Should the rate of "interest" used to determine the normal contribution rates for public sector pension programs be a risk-free rate? Or may it be appropriate to use a 'realistic' rate or a 'best estimate' rate which reflects expected interest rates from a low or moderate risk investment portfolio? Even if the answer to the latter question is "yes", should there be some cushion between the rate of 'interest' used to reckon contribution rates, and the rate of return which is aimed for in the long-run investment strategy? How big should the cushion be?

If a pension fund has a very high probability of much higher investment returns in the immediate future than any reasonable expectation of long- run returns, is it acceptable policy to use some of these streamed high returns to cushion an increase in contribution rates that might otherwise have to take place?

❐ *Comments*

Many actuaries and pension fund investment advisers now recommend that a low-risk, rather than a risk-free rate of "interest" be used to determine normal long run contribution rates. The Coward report's judgment on the risk-free rate of return for discounting fully indexed pension benefits in Canada is about two per cent real, but it recommends using three per cent real to reckon contribution rates. Professor Pesando's judgment is that the risk-free real rate of return is now three per cent and Keith Ambachtsheer indicates risk-free rates in the range of 2.5 to 3.5 per cent. A low risk, or "realistic" or "best estimate" real rate to reckon contribution rates would then be in the range of three to 3.5 per cent, closer to the upper than the lower part of this range. Ambachtsheer prefers to have a pension plan costed on a risk-free rate of return, but to have an investment policy which accepts risk and obtains better rewards, which can be subsequently used in a variety of ways, depending on the agreed sharing arrangements.

For pension programs like those of the teachers and public servants, total contribution rates reckoned on real rates of return of 3.5 per cent real would be two per cent of earnings per year lower (perhaps slightly more) than those reckoned on real rates of return of three per cent of earnings. That is to say, if a program cost 20 per cent of earnings or contribution rates calculated as three per cent real, the program would cost 18 per cent of earnings if contribution rates were calculated at 3.5 per cent real.

Investment advisers indicate that it is reasonable to be more ambitious in the target rate of return for the investment strategy of a pension fund than the rate which is used to reckon contribution rates. A moderate risk mixed market portfolio should be able to achieve a long-run real rate of return of between 3.75 per cent to 4.25 per cent real.

A pension program with contribution rates based on three per cent real but with long-run investment earnings of 3.5 per cent real, would generate surpluses on the average over the long run equal to about two per cent of earnings per year. Similarly for other combinations such as

contribution rates of 3.25 per cent and average real investment results of 3.75 per cent or 3.5 per cent - based contribution rates and four per cent investment results.

To the extent that high immediate prospects of streamed interest rates are not absorbed in meeting past service liabilities, they could be used to moderate increases in contribution rates in oncoming years.

- **Our Interpretation of the Views of Employee Representatives Regarding Contribution Rates**

The OTF, OPSEU, CUPE and OLBEU believe that contribution rates and their basis must be decided formally between the government and the plan participants' representative bodies.

The OTF believes that teachers already contribute a substantial amount to their pensions and that their contribution rates must reflect the increased earnings potential from a diversified investment program. They also believe that all assets, including surpluses, belong to plan beneficiaries.

OPSEU, CUPE and OLBEU strongly believe that contribution rates are a negotiating matter. OPSEU, CUPE and OLBEU do not believe that a contribution increase is necessary. They believe that because pension costs are extremely sensitive to minor economic and actuarial assumption variations and the current practice of setting these assumptions is extremely conservative, there is no need for a contribution increase. In addition, OPSEU, CUPE and OLBEU are concerned that lower wage employees are contributing more for their indexed pension benefits than higher salary employees are.

OPSEU, CUPE and OLBEU point out that the government should expect to contribute more than employees on an ongoing basis considering the PSSF's current funding basis. These unions do not believe that there is a basis for presuming that one half of the pension cost should be borne by employees and that the government should continue to guarantee the pension benefit.

SECTION VII

Basic and Inflation-Protected Benefits

Assuming that the larger the intended pension, the greater the contributions that are required, do workers wish to have large, medium-size or small pensions in comparison with pre-retirement income?

What are the preferred trade-offs between related pension benefits, such as withdrawal, early retirement, survivors' benefits, vesting and portability terms, and basic pension and contribution rates?

Would a mixed retirement income and saving program (partly defined benefit and partly defined contribution) be of interest to teachers and public servants?

Is the goal to provide complete protection of the participants against inflation - both for start-up pensions and for retirees? Or is the goal to provide partial protection of the participants against inflation?

Whatever the targets for inflation protection may be, are the undertakings contractual, ad hoc, or a mixture?

If the inflation protection of the pension programs of teachers and public servants is larger than in other public and private sector plans, how may the difference be justified? If the inflation protection turns out to be larger than may be required under the PBA, how may that difference be justified?

If the contribution rates acceptable to the parties, together with the investment returns, are insufficient to meet the indexed pension and related benefits, will benefits be reduced? If benefits are to be reduced, what is the trade-off between basic pension benefits, other benefits and lesser degrees of inflation protection?

❒ Comments

Under the teachers' and public servants' plans, for a participant with 35 years of service, the pension income, together with OAS and CPP, would provide about 76 per cent of the final year salary for a person earning $30,000, scaling down to about 70 per cent for a person earning $60,000 on retirement. These replacement ratios are generally regarded as satisfactory. In the Consultations, no one has suggested that these replacement ratios should be increased. Many teachers also receive substantive lump sum payments from their local school boards on retirement.

Under the proposed new federal tax treatment of retirement income arrangements, tax relief on contributions and tax sheltering of pension fund retirement income is to be limited in a comparable way for defined benefit and money purchase plans.

Under defined benefit programs, maximum pensions per year of service would be established, subject to escalation after 1994. For a person with 35 years of service, until 1994 the maximum pension for which tax relief of contributions will be allowed is approximately $60,000. However, under the proposals, the maximum pension limit does not restrict the number of years of pensionable service that may be taken into account in calculating the maximum. If a person had 40 years of pensionable service, the maximum pension could be about $69,000 and the program could still qualify for tax relief.

The PBA requires minimum vesting, portability and survivors' benefits larger than those which formerly were required by the teachers' and public servants' pension programs. The new requirements must be implemented under the authority of the PBA. If the existing basic benefits of the programs are maintained, except where improved to meet the PBA requirements, then the value and cost of the overall benefit package will be increased.

The most frequently encountered proposal for other improvements is for better benefits for early retirement. Both the teachers' and public servants' plans now have early retirement provisions, but beyond certain benchmarks, only for a discounted pension. Also, teachers have a special temporary three-year early retirement window, without discounting of pension. The non-discounting provision would be limited in future under certain circumstances by the proposed new Income Tax Act.

For active workers who belong to the teachers' and public servants' pension programs, the build-up of their pension rights is mainly protected against inflation by having initial pensions based on a final years average salary base. To illustrate, if a final five-year salary average is used as the base for determining the initial pension and inflation during the period average four per cent per annum, the final salary average would be approximately 10 per cent below the final salary.

For all practical purposes, both the teachers' and public servants' pension programs are fully indexed to a cap of eight per cent of CPI, with carry-forward provisions. The indexation is contractual rather than ad hoc; it was established by the SABA legislation. While a very strong case for such a policy of full indexation has been made, the degree of pension protection of participants in these two plans is clearly larger than in most other public and private sector pension programs.

For defined benefit pension programs, the record shows that society, employers and employees consider some measure and form of indexation of pension benefits is fair, reasonable and affordable. The issue is the degree and form of indexation, not whether there should be full indexation or none.

The Coward report recommends that the present arrangements for indexing the teachers' and public servants' pension programs be continued. It also recommends that the contribution rates be made adequate to fund the future indexed benefits and that employees pay 50 per cent of future costs. For private sector plans, the Friedland report recommends that, if mandatory indexation of future pensions be required for defined benefit pension plans, the indexing formula would be 75 per cent of the CPI, minus one per cent. This recommendation is a minimum level of indexation and incentives are suggested for higher rates of indexation on a voluntary basis.

Higher rates of indexation for some pension plans can be defended just as any other more generous pension benefit can be defended. There is no good reason why pension plans should be mirrors of each other. Indeed, they should have differences to reflect the choice and opportunities of their participants. Specifically, higher indexation in one program than in another can be defended as being paid for by some combination of higher contribution rates, lower other benefits, or trade-offs between pensions and other remuneration in a total compensation framework.

The corollary is the strong case for full disclosure of costs and explicit consideration of pensions in relation to total compensation.

In this connection it was suggested to us that we review the record of teachers' salaries over the last two decades. We did so by commissioning a paper by Douglas Auld and Harry Kitchen, which will be published in the supporting materials to the report on these Consultations. The paper provides mixed signals. In the 20 years between 1966 and 1985, Revenue Canada data shows that teachers' salaries have increased more rapidly than other federal or provincial public servants; however, they have increased less rapidly in recent years. On the other hand, data on base rates in collective agreements indicates that teachers' salaries have not increased as rapidly as those of other groups on average for the 20-year period 1968 to 1987, though there were, "explosive nominal wage increases in 1974 - 1975 and again in 1981 - 1982".

It is possible that either the teachers' or public servants' pension programs or both could choose a package of benefits and contribution rates and investment policies which would include a lesser rate of contractual indexation of pensions, or even an ad hoc indexation if that was permitted under the PBA. Whatever rate and method is chosen, the pension program needs sufficient resources to discharge the obligation or carry out the policy. Incidentally, a program that has a policy of achieving some specific average level of ad hoc indexing over a number of years must have available almost the same resources as a program with a comparable level of contractual indexing.

The most important difference between mandatory or contractual indexation of pensions and ad hoc indexation relates to transfers out of a plan. With mandatory or contractual indexation, the commuted value of an indexed benefit will be transferable under the portability provisions of the PBA. Previously even the most generous transfer provisions were much smaller, e.g., twice employee contributions plus some (often sub-market) rate of interest.

As the Coward report and Professor Pesando have shown, if an indexed pension program is adequately financed for non-inflationary circumstances, there will be little additional burden in real terms (per cent of earnings required to fund the pension program) over the long run to finance a pension plan over a wide range of inflationary possibilities.

The Coward report estimates that the improved benefits to meet the minimum standards of the PBA will require a joint additional contribution of 1.04 per cent of earnings for public servants and 0.76 per cent of earnings for teachers. For the existing fully-indexed benefits arising from future service, the Coward report estimates that it will take contributions totalling marginally above 19.7 per cent of earnings for the teachers' program and marginally above 17.1 per cent for the public servants' program. These contribution rates are estimated using "entry age normal" method rather than the "unit credit" method which is generally applied in private sector pension programs. For

the improvements plus the existing benefits, his totals are contribution rates of marginally above 20 per cent for the teachers' program and marginally above 18 per cent of earnings for the public servants.[1] These figures are reckoned on the basis of a long-run real rate of interest for determining the contribution rates of three per cent real. If 3.5 per cent real could be used, the required contribution rates for the teachers' package could be about 18 per cent of earnings and for the public servants package about 16 per cent of earnings.

Other actuarial estimates of required contribution rates for similar programs presented in the Consultations are in the same ball park as those of the Coward report for fully funded future benefit programs designed on an "entry age normal" basis.

While some downward shading or element of gradualism may be introduced, compared to the recommendations made in the Coward report, some increase in contribution rates appears to be necessary to put the plans on the road to good health. If the parties are unwilling to make such increases, then the issue will be reduction of existing benefits. Basic benefits could be reduced. Indexation of pensions could be reduced. Early retirement benefits could be reduced or other secondary benefits could be reduced. Or some combination of such choices could be made.

❐ Our Interpretation of the Views of Employee Representatives Regarding Basic Inflation Protected Benefits

All of the plan participant representative bodies want to retain their current level of inflation protection. OFL, OPSEU, CUPE and OLBEU require that all pensions be fully protected against inflation.

OPSEU, CUPE and OLBEU make the point that inflation can affect the value of a pension benefit before retirement if salary increases do not keep pace with inflation and if the pension benefit is calculated on the average of this lower real income.

SECTION VIII

❐ *Past Service Unfunded Liabilities*

Though disputes continue about the size, origins, nature and urgency of change, it is generally agreed that the indexation funds for the teachers' and public servants' pension programs had substantial unfunded liabilities as of the end of 1985; and the basic funds had at that time small surpluses. If contribution rates are not changed, if benefits are changed only to respond to PBA reform, and if the existing structure of funds is continued, the unfunded liabilities of the indexation funds would increase each year after 1985. The immediate prospect for the basic funds would probably be for increased surpluses, though with smaller annual increments than the incremental deficits on the indexation funds.

The unfunded liabilities on the indexation funds arise partly from inadequate contribution levels during the whole life of those indexing programs, although low investment earnings in some past years were a contributing factor. The unfunded liabilities have arisen mainly out of past service, but they will continue to increase unless contribution rates and investment earnings together are brought into alignment with the cost of the benefits that are accruing.

Only recently have the basic funds realized surpluses after many years of unfunded liabilities. The government made large extra contributions to the funds over many years. These extra contributions, the continued growth of the fund from regular contributions and more recently high rates of real returns on the investment funds compared with the rates used to cost and value the

1 All figures are from the Coward report.

basic programs, have given rise to the surpluses. Should the existing structure of the programs be continued, but with some increase in contribution rates? If so, should some portion of the unfunded liabilities be amortized? Who should pay? Are the surpluses on the basic funds to be used , in some fashion, to reduce the unfunded liabilities on the indexation funds?

As recommended by the Coward report, should a new system be established with the merging of the basic and respective indexation funds, followed by valuation of the merged funds, and amortization of the unfunded liabilities of the merged funds? Who should pay, and how much towards the amortization programs? Should the amortization schedules be adjusted in the normal way after each triennual valuation of the merged funds? What rate of discount would be used to value the assets of the merged funds?

Should some part of the surplus on the basic fund and some part of the high streamed earnings be put into a separate earmarked start-up fund on merging to pay for some of the improved benefits required by the 1987, PBA? Should an investment variation reserve fund be established? - Should the increase in the contribution rates for future service be cushioned? Should urgent improvements in benefits be met at this time? Aside from such a separate earmarked start-up fund and investment reserve fund, should there be a merger of the basic and respective indexation funds, valuation of the merged funds, and amortization of the unfunded liabilities of the merged funds?

❒ Comments

The unfunded liabilities arise mainly from past service liabilities accrued under the indexation funds. Even under the most favourable basis of valuation, these unfunded liabilities have become large. Ultimately they will impose burdens of future liabilities on the government of Ontario.

The unfunded liabilities will continue to grow from future service unless that process is terminated by some combination of increased contributions, increased investment earnings and reduced benefits. Proposals for increases in contribution rates are mainly related to putting the financing of future benefits on a sound basis. They would still leave the issue of accumulated unfunded liabilities.

The simplest way to deal with the issue of the unfunded liabilities is to accept the Coward report recommendations. However, that may not be acceptable to the interested parties. The report recommends simply merging the basic and respective indexation funds. This would result in all of the current surpluses on the basic funds and all the prospective high streamed investment earnings being used to reduce the unfunded liabilities.

The decision would need to be made whether the government must provide the whole of the past service unfunded liability after the merging valuation, or whether some part of it would be passed to current contributors through their contribution rates. If the government takes the whole of the amortization responsibility, it would have to decide on the schedule. An amortization program would normally be adjusted after each triennial valuation, and increased, held constant or decreased as experience permitted, to eliminate the unfunded liability.

In dealing with the financing of future benefits, it would be attractive to launch the program on a self-sustaining basis. This would be helped by transition measures:

- Funding the benefit improvements required by the PBA.
- Establishing an investment reserve fund, to assure the satisfactory investment performance during the change over to a market investment portfolio in what could be somewhat unfavourable circumstances.
- Cushioning the increases in the contribution rates, but not at the risk of large further increases in rates being required within a few years.
- Funding any other urgent improvements in benefits which may be instituted.

One possibility is to devote a part of the estimated surpluses on the basic funds plus a part of the high prospective streaming investment returns to earmarked start-up funds to meet some or all of the objectives set out. The remainder of the estimated surplus and streaming income would be absorbed in the determination of the accumulated unfunded liabilities.

For the PSSF, half of the estimated surplus as of December 31, 1986 would be little more than $150 million[1]. For the TSF, the equivalent figure would be a little more than $250 million[2]. Taking the asset values as of December 31, 1987 of more than $4.5 billion[3] for the PSSF and more than $11.7 billion[4] for the TSF, 100 basis points a year on the funds would be about $45 million a year for the PSSF and $117 million a year for the TSF. Five years commitment of streamed earnings at 100 basic points/years would thus amount to a little over $225 million for the PSSF and a little more than $585 million for the TSF. The estimated cost of pre-funding pension reform would be about $240 million for the PSSF and between $350 million and $400 million for the TSF[5]. Reduction of contribution rates by one-half point of earnings for five years for contributors and for the government would cost about $160 million for the PSSF and $360 million for the TSF.

If it was decided to continue with separate basic and indexation programs, and also to increase the degree of funding and rationalize the structure of the programs, then some definite commitments would be required. How and when would the funding targets be determined and realized? How would the accumulated under-funding liabilities be reduced? Would transfers of assets from the basic funds to the stabilization funds take place? On what authority? If so, how much and by what means? Are contribution rates to the basic funds to be decreased and the contribution rates to the stabilization funds increased as an offset? By how much more will the contribution rates to the indexation funds have to be increased to attain the future funding targets? How will the monitoring and adjustment of the performance be carried out?

❐ Our Interpretation of the Views of Employee Representatives Regarding Funded Liabilities

We believe that the employee representative bodies would strongly assert that all past service unfunded liabilities related to the SAFs are the responsibility of the government. There appears to be some concern that even if the government picks up the past service SAF unfunded liabilities, these costs could still be passed on to participants through other compensation components and/or through slower improvements in pension benefits.

SECTION IX

❐ *Minimum Requirements*

It may be best to launch the new pension deals for the teachers and public servants with agreement on a limited general framework and set of principles, and a 'bare bones' specific set of arrangement. Learning from the experience under the new arrangements, change and adjustments on the basis of changing tastes and opportunities.

1 The surplus of the PSSF at December 31, 1985 was reported as $109.9 million in the 1987 Annual report of the Public Service Superannuation Board. Various other estimates have been made informally using other actuarial assumptions. If surpluses are to be shared, the negotiating principals will have to agree on the valuation, perhaps as of December 31, 1987.

2 The surplus of the TSF at December 31, 1986 was reported as $461 million in the 1987 Annual report of the Teachers' Superannuation Commision. Depending on the actuarial assumptions the estimated surplus may be somewhat larger or smaller. On a different actuarial basis the Rowan report (p.135) reported the surplus of the TSF at the end of 1985 as $742 million. If surpluses are to be shared, the negotiating principals will have to agree on the valuations, perhaps as of December 31, 1987

3 The Rowan report (p.151) reported the assets as four billion dollars on December 31, 1986, with cash flow of over $500 million; thus the estimated assets at December 31, 1987 are over $4.5 billion.

4 Annual report, 1987 of the Teachers' Superannuation Commission (p.22).

5 Estimates derived from the Coward report.

- **The Agenda for Negotiations on Framework and Principles should include:**
  - Trust and trusteeship
  - Representation
  - Negotiability of pensions; collective bargaining frameworks
  - Mechanisms to break deadlocks
  - Intentions regarding self-containedness and self-supportedness
  - Explicit risk/reward sharing
  - Funding targets
  - Diversified market portfolios
  - Mechanisms for monitoring and making changes in all important aspects of Pension programs
  - Programs on a wind-up or going enterprise basis
  - Gradualism of adjustment, but assurance of policy objectives
  - Government guarantee
  - Indexation intentions
  - Target intentions on merging

- **The Agenda for Negotiation and Decision Regarding the Specific Elements of the Pension Deals should include:**
  - Benefit - Investment - Contribution Targets and Their Compatibility
  - Consideration of maintenance and improvement of existing benefits
  - Response to reforms required by the PBA
  - Basis for determining normal contribution rates
    - entry age normal or unit credit
    - "interest assumption": realistic/best estimate, risk free or low risk
  - Investment target - low, moderate or high returns; low, moderate or high risk; kinds of risks
  - Risk/reward sharing
  - Start-up fund: basis, size and use; investment reserve fund
  - General policy for coping with volatility and variations in experience, including investment experience
  - Past service unfunded liabilities
    - Relationship to surpluses and streamed investment returns
    - Who participates in the amortization schedules
    - The schedules, review and adjustments of the amortization performance
  - A review apparatus and schedule for the principals
  - First major future milestone

While there may be some common features in the framework, the "principles" and the "specific deals" for the teachers and public servants, it should be possible in the future, just as it is now, to have differences among the programs. It may be that some of the existing programs should be split into two or more programs and that each program might contain various options from which participants could choose.

In the next chapter the more specific options are presented.

CHAPTER 6

Options

Introduction

The government and the representatives of the teachers and the public servants have to make the choices on behalf of the taxpayers and the active and retired participants in the pension programs. While the government and the representatives are formally intermediaries between the taxpayers and the members of the pension programs, they will be treated as the principals for the purposes of negotiating among options.

Several packages of options are workable. The objective of this chapter is to set out the main choices of governance of the pension programs and the main choices of the pension deals.

While there is considerable flexibility regarding which specifics can be included in each group of choices, certain requirements are essential. The package chosen must be both financially and perceptually sound in the fundamental sense that the contributions and expected investment earnings should be planned as paying the benefits. The package should not deliberately perpetuate difficulties or be instrumental in generating potential future crises for the pension programs. Both the benefits that will arise from future service and the benefit entitlements accumulated from past service should be secure. The pension programs should be efficient. They should also be tailored to meet the preferences of the participants as expressed through their representatives and the government's responsibilities as employers.

SECTION I

❐ *Spectrum of Choice*

❐ *Government and Structure*

The spectrum of choice covers:

- full partnership - joint trusteeship
- limited partnership
- reformed status quo

The current status quo appears unacceptable to virtually everyone engaging in our consultations.

❐ *Pension Deal*

The fundamental choices of pension design as set out in the Rowan report are between defined benefit related plans at one end of the spectrum and pure defined contribution plans at the other, with various mixtures of hybrid and shared risk/reward plans in between these extremes. In a pure non-contributory defined benefit plan, the sponsor meets all the costs, bears all the risks and receives all the rewards of good management and experience. In pure defined contribution programs with little or no employer contribution, the members bear nearly all the costs, bear all the risks and receive all the rewards. In fact very few public sector plans in Ontario are pure defined benefit or pure defined contribution designs. They nearly all have some hybrid or shared risk/reward characteristics.

The teachers' and the public servants' pension plans in Ontario already embody an element of risk/reward sharing though they are strongly rooted in defined benefit models.

A central issue is whether, while retaining the core of defined benefit program, these plans should adopt more of a shared risk/reward design. The gains for doing so can be lower contribution rates and better benefits than would otherwise prevail as well as secure and independent programs.

The specific choices of the pension deals include:

- improved, maintained or reduced benefits
- immediate or gradual approach to sound programs
- low, moderate or high risk/reward strategy; and the associated relationships to costing, valuation and sharing in the investment risks and financial rewards in the pension programs
- increased, maintained or reduced payroll deduction and government contributions for the future service benefits
- size and amortization schedules for unfunded liabilities

❑ *Participation and Responsibility; Arm's Length Relationship to Government*

For a continued defined benefit program but with variations in risk and reward sharing, the choice of governance and structure is between full partnership joint trusteeship; partial or limited partnership; and a substantially reformed status quo with sponsorship by the government.

If a hybrid pension program is considered, consisting partly of a defined benefit component and partly of a defined contribution component, the choices of governance and structure can be chosen separately for each element or for the hybrid plan as an entire and complete program.

❑ *Full Partnership and Joint Trusteeship*

Under full partnership and joint trusteeship, what would be shared?

- responsibility for determining the fundamental relationships of benefits, investment policy and contributions required to ensure the security of the pension program;
- responsibility for recommending to the principals temporary or enduring adjustments in benefits and contribution rates required by adverse program experience and, equally, through favourable program experience;
- subject to the agreement of the principals on major policy issues, the responsibility for benefit policy, for investment policy and for contribution policy;
- responsibility for meeting the requirements of the provincial pension regulatory authorities and the federal taxation authorities;
- the sharing as agreed between the participants and the government of the risks and rewards, not only in investment performance but also of actuarial experience;
- the policy of program management of the programs to cope with transitory variations in investment or actuarial experience;

The sharing in the joint trusteeship could be anything on which the principals agree. It need not be 50 / 50, but such a division has the merit of being easily understood and communicated, easily administered, and it portrays an image of fairness and justice. [1]

[1] The 50% rule under the Pensions Benefit Act of Ontario, as it is now drawn, has the effect that the employer has to contribute more than 50% overall. This arises from the requirement that the employer must meet the 50% test for each individual.

Sharing and participation carry responsibility; responsibility is linked to sharing and participation. However, the precise arrangements have to be worked out among the negotiating principals and ultimately accepted by the legislative authority representing the taxpayers and the members of the pension programs.

If full partnership and joint trusteeship are chosen and instituted and sound pension plans put into operation, then this structure of governance has many attractions. We believe that this approach:

- Promotes equal responsibility of all parties.
- Promotes a sense of independence and involvement of individuals in their retirement income and related benefits.
- Improves the compatibility of the choices in the pension program with the membership's changing needs, circumstances and future opportunities.
- Could facilitate major improvements in membership appreciation, understanding, information and trust of the facts and analysis relating to the state of their pension programs.
- Places the pension programs at arm's length to the government and to the individual participants and their organizations, and at the same time respects the continuing role of government and of the representatives of the participants as intermediaries responsible for reaching agreements on major policy decisions while at the same time ensuring the pension program remains secure.
- Could facilitate a fair and accurate comparison of the performance of the teachers' and the public servants' pension programs with other trusteed public and private sector plans.
- Makes both partners sponsors and trustees; government guarantees would be terminated, but so would government right to make unilateral changes except in extreme circumstances of insecurity of the pension programs.

❐ *Limited Partnership*

One variant of a limited partnership could arise if a joint trusteeship is established for pension programs, but it is agreed that the government is to continue to carry the major share of the risks and will guarantee the benefit. The trustees could have all the responsibilities already outlined, but the Board of Trustees might be 60 - 40, or 2/3 - 1/3 (or some other agreed ratio) of government and members' representatives. The government would represent the majority position and would have the power to assure decisions; but it would have to give considerable weight to the minority views.

Another variant is for the shared responsibility to be for some part but not all of the elements of the pension program; e.g. investment policy. For the element with membership participation, the sharing could be equal or unequal depending on the nature of the deal and the agreement.

The Rowan report deals with the investment but not the other aspects of public sector pension programs, recommended substantial minority participation of members on the investment boards. This would apply even if the defined benefit deals as they are presently constituted were to continue, with government continuing to carry more than one half of the investment performance risk. The Rowan report further recommends equality of member and government representation on the investment boards if equal sharing of the risks related to the plan's financial security were a part of the new pension deal. This is a reasonable proposition.

It must be kept in mind that the Rowan report's terms of reference did not permit consideration of the overall governance and structure of pension programs. However, there is nothing in the Rowan report recommendations that can be taken as opposition to what we have called a full partnership and joint trusteeship, provided that the risk/reward aspects of the investment program of the pension deal involved full and equal sharing.

It is important in this context to recognize that the members of the plan now share in the overall risks of the performance of the plan through their impact on normal contribution rates.

❐ *Modified Status Quo*

If the government continues to be the sole sponsor and sole trustee of the teachers' and public servants' pension programs, (i.e., the "status quo"), considerable improvement will be required in sharing data and analysis, in being open and publicly accountable and in educating and communicating clearly, openly, explicitly and regularly. It is vitally important that confidence be developed and maintained in the relationship between benefits, the investment performance and the cost of the pension programs. A large measure of doubt, even cynicism, now exists in the minds of plan members and their representatives concerning the teachers' and public servants' pension programs. Of particular concern to these people are the state of the plan's funding; the past and prospective investment earnings; the extra contributions made by government; and the relationships between benefit levels, contribution levels and investment policy.

The new arrangements must be supported by jointly acceptable expert advisers, to develop and maintain confidence in the information provided to all parties on the design, valuation, investment performance and funding of the teachers' and public servants' pension programs in Ontario. A major improvement must be undertaken in communications programs with the participants. While participants are given information about their individual pension status on a regular basis, the standard of communication varies considerably. Also the individual's position should be put into the perspective of the overall program in which he/she participates.

❐ *Negotiability and Collective Bargaining*

The second major choice is whether or not to make most or all pension matters for teachers and public servants negotiable, and if so, what structure of negotiation and collective bargaining to seek among the principals. Though pension matters are not now negotiable, in fact the government and representatives of some employee organizations have engaged in discussions that appear to have lead to some agreements and attendant changes in pension programs. Do the principals want to open up the whole range of pension and related issues to negotiation and to do so formally, or to continue to build on the ad hoc arrangements which now exist?

A corollary of the issues of negotiability and collective bargaining of pensions concerns the desirability of the pension legislation being drawn in more general terms, permitting some changes by regulation and agreement.

In one sense, to agree to negotiability of pension matters with the teachers would be a simple step because the OTF has a long and successful history of dealing with the government on pension matters. In another sense, negotiability and collective bargaining raises difficult structural issues between the teachers and the province. As discussed in chapter 5, the local school boards, not the province, are the employers of teachers. Pensions have not been part of the collective bargaining process between local teachers' organizations and local school boards. If this structure continues, some way must be found to impress the pension facts on the minds of those engaged in collective bargaining at the local school boards. Estimates of the costs of pensions as part of total compensation could be provided to school boards and local teachers' organizations by the Education Relations Commission. The data on the costs of teachers' pensions could be a part of the information on education costs and provincial grants to local school boards. Perhaps pension costs could be added as a line item in provincial education grants to school boards, with the school boards being billed for the pension costs incurred by the province.

For the public servants, as was shown in chapter 5, the principal problem of making pensions negotiable, is that 30 per cent of the employees do not belong to a union or association which represents them on matters of salary or benefits or working conditions. Who is to negotiate pensions on their behalf? The choice would be simplified if the public servants' pension programs were split roughly along the lines of the sectors most likely to be unionized and non-unionized, with options to employees at the margins as to which plan they join.

The other problem is that the unionized sectors covered by the public service pension plan are divided among a number of unions, with different characteristics and constituencies and different interests in pension programs and related benefits. The choices may be aided in these circumstances by making available a simple core pension program, and a set of options or supplementations, such as the OPPA early retirement supplement.

Consideration will have to be given to coordinating the cycles of collective bargaining on shorter term matters such as wages and salaries, and longer term matters such as pensions. Depending on the structure, the negotiations might be separate but coordinated, or sub-negotiations could be organized under an umbrella arrangement.

As has been argued rather extensively in earlier chapters, if pension matters are to be negotiable, and if representatives of participants have major power and authority as joint trustees of the pension programs, then a considerable measure of harmony and compatibility has to be worked out between the trustees' responsibilities and the collective bargainers-cum-negotiators' responsibilities.

❒ *Packaging*

Ultimately for the teachers and for the public servants it is necessary to consider all elements of the changes as a package. However up to a point it is helpful to consider some elements separately. One objective is to put the pension and related benefit program which will arise from future service on to a sound and acceptable basis. Another distinctive objective is to clear the unfunded liabilities from past service. The Coward report's major recommendations deal with both of these objectives. If other models are to be considered, they too must deal with both of the objectives.

The fundamental arguments for merging the respective indexation programs with their basic programs are set out below. As will be shown, a strong case can be made for merging them, or at least coordinating the programs completely and carefully. It is recognized that it would be possible, for an indefinitely long period, for a modified pay-go approach to indexation of teachers' and public servants' pension plans to be continued. But fundamental changes would have to be made in the joint policy, with respect to accountability, valuation, funding, contributions, decision-making, and communication of the unmerged programs. They would have to be thought of, managed and evaluated as if they were merged, even if separate accounts were to be retained.

❒ *Self-Containment, Self-Sustainedness and Funding*

In chapter 5, Self-Containment and Self-Sustainedness of pension programs refers to the objectives that normal contribution rates, together with reasonably attainable investment earnings, should meet the pension and related obligations, without large unexpected crises of curtailment of benefits or increases in contributions. Soundness, predictability, security of all fundamental aspects of the pension program are synonyms.

The program should have a built-in capacity to cope with the inevitable transitory variations in experience, including investment experience.

For exceptional periods of "bad news" which will arise in the life of any pension plan, a choice will have to be made between special adjustment programs when they arise, or a large and expensive reserve of assets to cope without placing (temporary) increases in contribution rates. Some comfort arises from the fact that exceptional periods of "good news" are as likely as exceptional periods of 'bad news' over the long term life of pension programs.

As it has been more fully discussed in chapter 5, funding, full or partial, is primarily to increase the security of pension programs. Funding is essential for pension programs of sponsors that are not blessed with immortality; thus full pre-funding targets are an almost universal requirement of private sector defined benefit pension programs. Funding is not essential for government-sponsored programs because governments have both immortality and sovereign taxing powers from which to meet their obligations.

While funding is not essential for government-sponsored pension plans, it is nevertheless a valuable objective for the participants and for the government. It increases the security of the pension program. It makes arbitrary curtailment of pension benefits less likely. It provides participants with a focal point for evaluating their assets and future income. It provides a link between their contribution rates and their expected future benefits. It is an embodiment of a saving program of the contributors. It gets compound interest working for the contributors.

Soundness, predictability, security, self-containment and self-sustaining aspects of pension programs can be pursued both in programs that aim at full funding and those which aim at partial funding. However, under partial funding, as compared with full funding, the targets are less clear; the performances in relationship to the targets are often difficult to evaluate; the predictability and deliverability of the required increases in contributions are less firm.

Except under unusual conditions of growth and structure of the membership of a pension program, in the long run the contribution rates for a similar set of pension benefits will be larger under a partially funded program than under a fully funded program.

If full funding becomes the policy for the pension programs of teachers and public servants,are the funds themselves to be the security for the pension programs? Should government guarantees of the pension programs cease? The principals must decide, but the logic suggests "yes" as the answer to both questions.

❐ *Market or Non-Market Pension Fund Investment Portfolio*

The choice has to be made as to whether the pension funds under consideration would be permitted and encouraged to be invested in market portfolios, or continue to be invested in non-market portfolios, albeit under changed terms and conditions.

New non-market policies could be chosen. Under the proposals now being considered for the federal public service, a non-market investment fund would continue, but with investment earnings being credited to the fund on the basis of the actual investment performance of 10 large external market-based pension funds. Some equivalent could be considered for the Ontario teachers' and public servants' programs. Alternatively, the crediting of investment earnings to such a fund could be based on the performance of agreed market indices, such as the Scotia McLeod bond indices and TSE-300 earnings index.

Sentiment for shifting to market portfolios is very strong among the teachers and public servants, and is overwhelmingly supported by investment analysts, managers, taxpayers and other interested groups. Long-run increases in investment earnings beyond those which have been and would be yielded from the existing policy are generally expected. The perceived shortcomings of the existing investment policy are many: intangibility of the assets; low investment earnings; insensitivity to changing investment opportunities; conflicts of interest and government arbitrariness.

❐ *The Options Based on the Coward Report's Recommendations and Variations Therefrom*

For both the teachers' and the public servants' pension programs, the Coward report recommendations are:

- Maintain the existing benefits, including the present undertakings for indexation.
- Carry out the reforms required to bring the plans into conformity with all the requirements of the PBA.
- For future benefits, determine the contribution rates on an entry age normal basis, and on the basis of merged indexation and basic programs.
- Use three per cent real rate of return to cost and value the future benefits, and to determine future normal contribution rates. Since the Coward report considers the risk-free rate of return to be two per cent real, the recommendation implies use of a low-risk market rate of return for costing, valuing, and determining the contribution rates.
- The funds are to be gradually shifted from the existing non-market portfolio to a market portfolio.
- Set the contribution rates for full funding of future benefits.
- Merge the inflation adjustment funds with their respective basic funds; then value; and then determine the unfunded liabilities.
- The government should amortize the unfunded liability over 15, or if authorized, 25 years.
- The government should continue to pay the indexation liabilities for pensioners who retired before 1976 from the consolidated revenue fund (CRF).
- Divide the costs of pension benefits that will be earned in the future, including indexation.

The Coward report calculates the current contribution rates that would be required if they not only had to cover future benefits but also had to discharge the accumulated unfunded liabilities. For the teachers' program the joint requirements would be over 25 per cent of earnings and for the public servants' program about 23 per cent of earnings. The Coward report does not recommend such a policy. We agree with the Coward report's view because, in our opinion the rates would be very high and the distribution of the burdens and benefits would be considered so completely unfair that such an arrangement is not a realistic option.

The Coward report recommendations concerning funding of future service liabilities, or an updated version of them, are a real option. The Coward report states that the normal contribution rate to be shared between the government and the participants would have to be marginally above 20 per cent of earnings for the teachers' program and marginally above 18 per cent of earnings for the public servants' program. In addition, the government would have an amortization schedule for the unfunded liabilities of over $650 million per year for 15 years on the basis of the unfunded liabilities at the end of 1985 (more now, because the unfunded liabilities are currently larger than at the end of 1985).

For helping with the negotiation of the new deals, it may be helpful to establish an ad hoc advisory group of experts chosen by the government and the representative external bodies to advise them both. The group should include expertise on actuarial and investment matters. The purpose of the group is as much the building of confidence among the partners as advising on technical matters.

❒ Variation One

The first variation that we might offer on the Coward report recommendations is to consider basing the costing, valuation and determination of the contribution rates and investment policy on a higher target real rate of return or discount. If 3.5 per cent real instead of three per cent real were used throughout, and everything else in the Coward recommendations were maintained, the combined cost, including pension reform for the teachers' program, would be marginally above 18 per cent of earnings, and for the public servants' program about 16 per cent of earnings. As reported in chapters 4 and 5, we have been advised by Professor James Pesando that three per cent real is a reasonable figure for risk-free rate of return, implying that a low-risk rate of return would be above three per cent. Keith Ambachtsheer judges the risk-free rate of return to be in the 2.5 to 3.5 per cent range, and the moderate-risk rate of return target as four per cent. Other eminent actuaries have advised us that "realistic" or "best estimate" real rates of return on pension funds are in the three per cent to four per cent range.

We believe that it would be sound policy to value, cost and determine the normal contribution rates on the programs on the basis of a real rate of return or discount in the three per cent to 3.5 per cent range, leaning more to the upper than to the lower end of the range. We believe also that it would be sound policy to examine the degree of necessity for the other safety margins which are normally built into the design and costing of the programs. This task may be assigned to the ad hoc advisory group to advise both of the negotiating principals.

The choice between the "entry age normal" method, which is now in use for both the teachers' and public servants' pension programs and the "unit credit" method of determining contribution rates is essentially an issue of distribution of costs of a pension program among cohorts or generations of participants. Plan member representatives have suggested that the "unit credit" method be used for costing plans. Substituting the "unit credit" method might slightly lower contribution rates today but not by much because of the high average age of members of the plans. Reduced contribution rates now would be at the expense of higher rates in the future. Nevertheless, the principals may wish to consider whether the "unit credit" method would be appropriate in light of all of the other burdens likely to fall on contribution rates in the immediate future.

❒ Variation Two

Another major variation on the Coward report recommendations concerns the combinations of costing targets and investment targets for the programs. As discussed in chapter 5, the target for investment policy may aim for a higher reward and accept a higher risk than the target for costing and valuation of the program. The costing target - investment target combinations might be three and 3.5 per cent real, or 3.25 and 3.75 per cent real, or 3.5 and four per cent real. In a pension program like that recommended by the Coward report the financial realization of any of these combinations would generate a long-run trend of surplus averaging about two per cent of payroll per year.

We have been advised by many investment managers and advisers that, on a mixed market portfolio which carries moderate risk, pension funds in Canada can reasonably aspire to real rates of investment return in the 3.5 per cent to four per cent range - more toward the top than the bottom.

A choice, then, is whether to strike the initial new deal on the expectation of a moderate risk long run real rate of return on a mixed market portfolio, and to shade down the start-up contribution rates a little because of this. Expectations must not be set unrealistically high, and some caution should be exercised in "counting the chickens before they have been hatched". Also, it would have to be recognized that given more ambitious investment targets , more variability and volatility will have to be coped with. The pension plan management will have to operate policies to deal with the variability and even consider from time to time short-term adjustment programs in benefits and contributions. But the choice is a real one.

❐ Variation Three

The next variation on the Coward report theme concerns choices between immediate and gradual approaches to the full funding target recommended by the Coward report. As a working example, consider the following supposition: using recent data and making allowances for the higher costing and valuation rate and the higher investment target, the average contribution rate over the next 10 years to fully fund the teachers' program (including reform) would be 18 per cent of earnings, compared with the current contribution rate of 15.8 per cent of earnings. The question would be whether the principals would prefer to move immediately to the 18 per cent or enter into a schedule of phased increases over (say) 10 years that would be equivalent. The terminal rate might have to be more than 18 per cent to compensate for the initial rates being under the averaged target? Could a process of monitoring and review be instituted which could adjust the schedule in the light of experience under the revised plans? The investment program just might turn out to be significantly better or worse than the target. If better, the increases in contribution rates may be limited or even reduced.

To illustrate a phasing proposal over 10 years, the following schedule is equivalent to a 10-year average of 18 per cent: a first year of 17 per cent of earnings with an increase of 0.2 per cent of earnings each year, terminating in a rate of 18.8 per cent of earnings in the 10th year. It might then be reduced back to 18 per cent or lower if experience warrants.

❐ Earmarked Start-Up Funds - Transitional and Investment Reserve

In the discussion of issues, the attractiveness of establishing and using earmarked start-up funds and investment reserves beyond those necessary to fund the benefits arising from future service in the new pension programs was set out. They could be used:

- to fund pension reform
- to establish an investment variation reserve program
- to cushion the start-up contribution rates
- to fund urgent improvements in benefits

We realize that the "saying" about there being "no free lunch" applies to this suggestion. In chapter 5 we had explored the possibility that earmarked start-up funds might be launched from some portion of the surpluses in the existing basic funds, or a share of the high-streamed investment earnings in prospect for the next few years, or with some combination of the two. But if the funds are started in this way, there will be fewer valuable assets available to the merged funds and, as a result, larger unfunded liabilities on the initial valuation of the merged funds. The required amortization schedule would thus be larger. The trade-off, therefore, is between larger or smaller amortization payments (which will fall mainly on the government) and smaller or larger current contribution rates, which the government would share with the participants if the funds are established and used as indicated.

The trade-off of improved future program against higher amortization payments may nevertheless be worthwhile. A more satisfactory long-term solution may be achieved. The pension programs could be more aggressive in their investment targets and the government could share in the higher average long-run rewards. The prospects for some future easing of contribution rates by the government as well as the participants may be improved. A more saleable package could be achieved. Pension reform could be financed. Under a fully shared risk/reward deal, both the government and the participants could share in higher average investment rewards.

There are indications that the value and duration of the current and short-term prospective high streamed investment returns may have been estimated very conservatively. The prospective streamed earnings and their value in the estimates of the Coward report should be re-examined very carefully. If they provide somewhat more "elbow room" in launching the new deals, then the case for some contribution to the proposed "start-up" funds becomes more palatable.

❐ *Continuation of "Modified Pay-Go" Approach to Teachers' and Public Servants' Pension Programs*

The option of continuing the current unmerged TSF/TSAF and PSSF/PSSAF respectively on a modified "pay-go" basis is a real one, but only if substantial modifications are made to the relationships between the basic and indexing fund arrangements.

The fundamental attraction to not funding fully immediately is that there will be lower contribution rates in the immediate future than those possible under the Coward-type options (but ***not*** lower than today's contribution rates), in exchange for higher contribution rates in the future. The cost of pensions is transferred from present to future cohorts or generations.

We expect that the resources available to the teachers' and public servants' pension programs from investment returns in the long run from market portfolios will be larger than they have been historically under the existing policy. But we are profoundly sceptical of two points of view - (a) that they can be so much larger that the fully indexed and reformed benefit programs can be delivered for the current contribution rates; and (b) that the SAF's will become mature, healthy funds mainly through a diversified investment strategy.

Even if the basic plans and the indexation funds are not formally merged, the design, valuation, investment policy, benefit and contribution rates of the basic plans and the indexation plans must be considered together, and presented to all interested parties together. The existing fragmentation has given rise to confusion and misunderstanding. Corrective action has been made more difficult and it has been delayed. Improvement in the communications on the performance and status of the program as a whole and complete entity and of the relationships of the various pieces is essential.

Sooner or later, the contribution rates to the combined basic and indexation parts of the respective plans will have to be increased. The longer the increases are put off, the larger they will need to be. It may be that reduction in the contribution rates on the basic plans could be transferred to the SAFs. But such transfers will not be enough to put an unmerged indexation plan on to a satisfactory basis. Moreover, transfering contribution rates between basic plans and indexation funds is fundamentally an unsatisfactory approach because the respective burdens on the two will shift back and forth, depending on the future developments of inflation and other economic and demographic events.

If the separate funds are to continue and modified pay-go principles are to apply, agreement must be reached on the conditions under which changes (likely increases) in contribution rates will take place and the determinants of their size. The existing annual review process is ineffectual. If the degree of funding is decided, and it is less than immediate full funding, then some body must be established and given the authority to determine what contribution is required to meet whatever funding objectives are agreed on, and to require timely decisions to implement what is required.

The public accounts of the province should present the revenue, expenditure, assets and liabilities, and valuation accounts of the unmerged funds and their relationships (including their funding status in relationship to agreed policy) openly and in forms which facilitate the evaluation by the participants and the public at large.

If an indexed pension plan is to be designed and operated on a partly rather than fully-funded basis, it has all the problems of a fully-funded program and more. The benefit - investment policy - contribution rate relationships must be determined as does the risk-reward strategy for the investment fund. The basis for determining contribution rates has to be decided. The issues of participation and responsibility and relationships to collective bargaining are the same as for fully funded programs. But in addition, awkward processes with uncertain outcomes of the pay-go decisions have to be faced repeatedly. If, in addition, the components of a program are in unmerged funds that are not reconciled easily, even more confusion is added to what are already complex issues.

Partly funded, unmerged programs are a real option, but not a very enticing one. The legitimate concerns for gradualism in adjustment, learning by experience, and sound pension programs appear to be more effectively resolved within the framework program which has the target of being fully funded.

❐ *Reduced Benefits*

If the contribution rates and reasonably attainable investment returns of the teachers' or public servants' pension programs are insufficient to meet the benefit schedule which the Coward report recommends, then the options are to either reduce the benefits to what can be managed in a sound plan or to raise further the contribution rates, or some combination of the two.

The least drastic approach to benefit-contribution rate changes would be to aim for a program like that of OMERS or the TTC. The basic benefit could be adjustable as in the TTC program. The indexation could be partial, and if permitted under the PBA, ad hoc as in the TTC or OMERS program. An excess earnings form of indexation might be considered.

If the shortfall of resources of the pension programs is severe and contribution rates are at a ceiling tolerable to the participants, more drastic reduction of benefits may be required. For example, drastic cuts in benefits would be required given the following circumstance.

If after all the possibilities for reduced costing, improved investment earnings, and gradualism have been explored, it might be concluded that while a proposed pension program would require contributions of 20 per cent of earnings, the parties can only agree on a maximum contribution of 16 per cent of earnings, then the issues concern reductions of benefits. They could be in basic benefits, preserving the full indexation and early retirement and other benefits. Basic benefits would have to be cut by about 20 per cent. Or they could be entirely in the degree of indexing; in which case indexing might have to drop from full coverage of CPI increases capped to eight per cent plus carry-forward, to about 30 per cent of CPI.

Many other possibilities could be considered. But the main point is that the gaps between the current and the required contribution rates for the existing programs plus reform appear to be significant even under the best of circumstances. Even if the government picks up most of the existing unfunded liabilities, it is difficult to envisage the required joint contribution rates below the 17 to 18 per cent of earnings range for the maintained and reformed teachers' fully indexed program, and below the 15 to 16 per cent of earnings range for the public servants programs.

❐ *Unfunded Liability*

It is generally agreed that, as of the moment, the basic funds of the TSF and the PSSF are in surplus, and the respective indexing funds would show much larger unfunded liabilities if valued on a funded basis on either a unit credit or an entry age normal basis. It is noted that, under existing legislation, full funding is not required for the indexation funds.

It is also widely recognized that the current and immediately prospective rates of interest earnings on the funds are larger than historic real rates and the rates that would be used to value and determine the contribution rates of such pension programs.

If the TSAF, PSSAF & RSAF and their respective basic funds are to be merged, what are the options for determining and discharging the unfunded liabilities?

One option is to accept the Coward report's recommendation regarding the unfunded liabilities. This is to merge the funds; value the assets and

liabilities of the merged funds; and determine the size of the unfunded liability as the difference between the value of the liabilities and the assets on merging. The future service contributions and liabilities would have already been put on to a sound basis by increasing contribution rates and the investment policies. The unfunded liability would arise from the past service liabilities (the indexation of pensions of persons who retired before 1976 would continue to be a charge on the CRF). The Coward report recommends that the government amortize the unfunded liabilities.

Under this option, the surpluses of the existing basic funds and the streamed prospective investment returns would be absorbed into the determination of the unfunded liabilities. This is the option embodied in the balance sheets set out in Appendix F of the Coward report.

While placing all of the burden of the unfunded liabilities on current contributors is not a real option because of the size and inequity that would be involved, there is an option of placing a portion of the burden on these contributors. The argument that could be made is that some of the current contributors have benefited, and will benefit in the future, from the developments which contributed to the unfunded liabilities. Governments are mainly responsible and should bear most of the burden, but some of the burden might be placed on current contributors. Even if the argument is correct, enormous practical and ethical difficulties arise in determining what share should be placed on the current contributors and how it could fairly be distributed. It is worth noting that at one time the federal government considered imposing past service unfunded liabilities on current contributors in its plans to reform the federal public service pension program; that proposal was abandoned for the reasons suggested here.

Another option is to to earmark a portion of the surpluses on the basic funds and a portion of the exceptionally high real investment earnings expected during the next five years for the earmarked start-up and investment reserve funds. Such funds could be used, for example, to fund pension reforms, to start an investment fluctuation reserve, and perhaps, partly to cushion the increases in contribution rates during the next five to 10 years. The negotiating principals might consider earmarking one-half of the surplus and one per cent of the nominal rate of interest on the assets for an agreed term, such as five years, to such funds.

In our opinion, the arguments about the origins and ownership of the surpluses do not come down strongly on the side of the government or on the side of the participants. The attempt to apply the Rowan report distinction between actuarial and investment risk surpluses retroactively would be very subjective and complex, and this is acknowledged by the Rowan report. The distinction might be applied in the future if the parties agree to the proposal in new pension deals.

Whatever way the unfunded liabilities are determined on merging, the only practical option is government amortization. The Coward report recommends that this take place over 15, or, if permitted, 25 years. It presents various timing schedules, but appears to favour a flat annual rate of amortization. Consideration might be given to a schedule which increases over time more or less in line with the long run growth of the gross provincial product or tax base.

While the Coward report does not say so explicitly, it presumes that normal amortization practices would be followed. That is to say, after each three year valuation of the merged plans, (or whatever period of time is agreed upon) the amortization schedule could be adjusted in light of experience. It would be important for the principals to determine policy in this respect.

The Coward report proposal on amortization is based on the assumption that the existing defined benefit pension deals will continue. The report also interprets those deals as placing all of the burden of the deficiencies on the government, as sponsor, and entitling the government to all surpluses. Under this proposal and interpretation not only would all current surpluses and prospective high streamed investment returns be used in determining the unfunded liability, but any better-than-expected future investment returns or favourable actuarial experience would reduce the government's amortization payments for the whole term of the amortization schedule.

While such an arrangement is consistent with the Coward report's assumption and interpretations of the existing pension deals, it would not be appropriate if a fully shared risk/reward pension program is agreed upon. Under such a program, the rewards of favourable performance would be shared between the participants and the government. The participants could not be expected to accept a fully shared risk/reward program and then have to wait 15 or 25 years for any share of the rewards. The quid pro quo for entering such an arrangement and accepting the risks of potential unfavourable experience is to share in the rewards on a reasonable timetable if they arise.

It may be that a special approach to amortization of the unfunded liabilities should be used in these circumstances. The amortization schedule might be established as an unconditional contract between the government and the funds, and thus taken on to the balance sheet of the merged funds as an asset of definite value to offset the unfunded liabilities arising from past service. Then the future risk/reward experience could be shared as agreed by the members and the government.

Chapter 7

Conclusions and Recommendations

SECTION I

❐ *Necessities and Opportunities*

The following factors in particular have come together to make major improvements for the pension programs for the teachers and public servants necessary.

- Under the best conceivable prospects, current contribution rates and available assets will be insufficient to pay for the pension benefit levels now in place. The imbalance holds for both the pension benefits that will arise from future service and for pension benefits that have already arisen from past service.
- Considerable mistrust, doubt and scepticism already exists between the provincial government and the teachers and public servants over pension matters. Unless there is substantial improvement in the consensus on pensions, serious deterioration in labour and human relations could occur.
- The recently revised PBA will require formal changes in the pension programs for teachers and for public servants, particularly regarding vesting, portability and survivors' benefits.
- The revised federal taxation proposals regarding pensions, savings and other retirement income programs may impose or induce changes in the pension programs for teachers and public servants in Ontario.
- The schedule of increases in the contribution rates to the CPP may have an impact on the employment pension programs for teachers and public servants in Ontario.
- Revised accounting standards for public sectors, including those for pension programs, would affect the public accounting and probably also the substance of the pension programs in public sectors in Ontario.

Among the number of factors that have come together to create opportunities for new deals on the pension programs for teachers and public servants in Ontario at this time are the following:

- The issues are now in the open. Careful up-to-date analyses are now available. The understanding of the problems and possible solutions has increased, even though much misinformation persists.
- While the Coward and Rowan reports on public sector pension plans in Ontario have been surprising, and while there is far from a consensus on the facts and their interpretation, the basis for a much wider consensus has begun to appear.
- Many more people have become interested and knowledgeable about pension issues in recent years. Networks among these interested persons have begun to appear.
- A "window of opportunity" has emerged for working out new pension deals of lasting value during this year and the next because pension reform has to be addressed during this period and because a sense of urgency now surrounds pension issues.

After many years of relatively low rates of investment earnings on the investment funds of the teachers' and public servants' pension funds in Ontario, both now earn good average rates of return relative to other pension programs.

Given that inflation has been lower and more stable for several years than it was between the early 1970s and early 1980s, the opportunity for a more temperate resolution of longer-term pension issues now exists.

SECTION II

❐ *General Objectives For Improvement of the Pension Programs*

In the most general terms, the objectives are:

- To put the future benefit - pension fund investment - contribution rate relationships of the pension programs for the teachers and the public servants on a sound, self-sustaining basis.
- To eliminate the problems those programs have accumulated from the past.
- To put in place vigorous and effective processes of monitoring and decision-making for the future which will ensure the continued soundness of the pension programs, and which will provide means to adjust the programs to the changing needs, preferences and opportunities which will emerge.

While there are important common decisions to be made for the teachers' and public servants' programs, there are important differences of application and even a number of important separate issues. We will come to these below, but we will first review the common ground.

SECTION III

❐ *What Policies Have Strong Support, Weak or Mixed Support; and What Are Opposed and Why?*

❐ *Strong and Broad Support*

The following proposed policies have strong and broad support among the teachers and public servants and their representatives as well as among a wide range of other interested parties:

- Transformation of the responsibility for the pension programs into institutions that are at arm's length to the government and to the participants (and their unions, associations and federations).
- Achievement of much more formal participation and acceptance of responsibility for the pension programs by the participants than now exists.
- Retention, if at all possible, of the benefit structure and indexation of pensions that now exist for the teachers and public servants; completion of the adjustment of the benefit structure and funding of the minimum reforms required by the recent changes in the PBA.
- Provision of the opportunity for some improvement in the pension and related benefits for the persons who are least served by the existing programs.

- Transformation of the investment portfolios into mixed market portfolios which accept at least low, and perhaps moderate risk.

- Some degree of risk/reward sharing that is explicit and direct, rather than implicit and indirect, with respect to both investment and experience variations from targets; there is wide but not universal support for full sharing of the risks and rewards under an institutional arrangement of full partnership in a joint trusteeship

❐ *Mixed or Lukewarm Support*

Among the proposed policies for which there is mixed or lukewarm support are the following:

- Transformation at this time of the programs into complete 'hybrid' plans which would include a defined benefit and a defined contribution component (perhaps with the defined benefit component being put on to a non-contributory basis); while such innovations or various "cafeteria" options within the pension programs may be attractive in the future for teachers or public servants, we did not find much enthusiasm for making such changes at this time.

- Particularly on the part of the teachers' organizations, there is little enthusiasm for the immediate merging of the indexation fund and the basic fund. Merging does not appear to be opposed in principle; the argument appears to be that the conditions for a successful and equitable merger do not now exist. In addition, the argument is that with certain changes in policies (the increased investment earnings in the future from 'diversification' of the investment portfolio plus some modest increase in contribution rates) the conditions for a successful and equitable merger will develop in the future - and the merger should not take place until then.

- Teachers and public servants have some reluctance in terminating the government guarantee. There is, however; fairly general acceptance of the proposition that the pension programs should become self-contained and self-sustaining, and even that risk/reward sharing should be explicit and substantial.

- The majority of teachers' and public servants' representatives believe that they own pension plan surpluses. The Coward and Rowan reports take somewhat different positions and the legal research for the Friedland Task Force is ambivalent on the matter. It is accepted by many that, particularly if the pension funds are invested in market portfolios, there will be swings from surplus to deficit and back again from year to year and valuation date to valuation date. It is also generally agreed that it is acceptable policy to use such transitory surpluses to balance off transitory deficits and preserve some stability in benefits and contribution rates. Further, if a policy of high average ad hoc indexing of pensions is to be carried out by a pension program, it will have to accumulate substantial surpluses from time to time in order to secure that policy.

  What is at dispute, however, is the use of a persistent trend of surpluses; that the only use that can be made is increased benefits; some argue that they should only be used to increase benefits; i.e. that their use for reducing contribution rates, including shared reductions of contributions by employer and participants would not be permitted, even if agreed among the principals.

Widespread General Opposition

Certain policy proposals generated widespread disagreement as expressed in the following points of view:

- Opposition to building in excessive safety margins in the pension programs. This would make them needlessly costly, with high contribution rates for the benefits, particularly when compared with other well-managed public and private sector pension programs. There is a strongly and widely held view that actuaries still build large safety margins into the design and costing of pension programs. We believe those perceptions are exaggerated, but perceptions of those affected weigh heavily in dealing with pension programs.

- Opposition to introducing large immediate increases in contribution rates, for little or no improvement in benefits. Most people expect that some program of increase in contribution rates will be necessary not only to preserve the existing benefits, including full indexation but also to provide for modest improvements in the benefit programs. There is a widespread feeling that the increases could be smaller and more gradual than those proposed by the Coward report and that if the teachers' and public servants' programs are run like other large well-run public and private pension programs in Canada, in the long run they will be less costly than suggested by the Coward report. The view is also widely held that trustworthy machinery and processes should be put in place, so that, if this optimism turns out to be unwarranted, the necessary long-term adjustments in benefits or contributions or both could be put in place in a timely fashion.

- Opposition to introducing an overly rigid, complex, unrealistic integration of pension matters into total compensation packages. While the Rowan report recommendation to consider teachers' and public servants' pensions in a total compensation framework should be implemented, it should be done with a clear recognition of the imprecision of the measures, the need for patience in making adjustments and for the divided jurisdictions.

- Opposition to imposing a large measure of the past service unfunded liabilities onto current contributors. Both the contributors and knowledgeable external parties are of the view that the SAFs were known to be underfunded from the start, that the government chose to make the indexation benefits retroactive; that indexation of benefits should be afforded pre-1976 retirees; and that the government should have informed themselves of the need for increased contribution rates many years ago and taken steps to correct the situation.

Our Views on the Reconciliation of the Policy Proposals

- In our view, the policies that have strong support and those that have mixed support provide a good starting point for the negotiating principals to work out new pension programs for the teachers and public servants in the immediate future.

- We further believe that many of the legitimate concerns over the policies that people oppose can be reconciled.

- We believe that it is possible to reach agreement on a reasonable approach to safety margins and approaches to contribution rates.

- We believe that an element of gradualism could be worked out for the increases in the contribution rates.

- We believe that the conditions for successful and equitable mergers of the basic and stabilization funds could be created, and that merged programs could be more successfully run than unmerged programs in the future, even if they were better coordinated.
- We believe that a sensible use of total compensation frameworks can be introduced for the pension funds, although we recognize that the problems in doing so may be greater for the teachers' program than for the public servants' program.
- We believe that a moderate-risk design of the pension programs could be developed, with acceptable risk/reward sharing, and with acceptable contribution rates for a good package of benefits.
- We do not believe that there appears to be any practical and equitable way to impose the burden of the unfunded liabilities on the current contributors. Fortunately, high streamed investment returns on the basic funds for the next five to 10 years could ease the burden somewhat in rectifying the situation.

SECTION IV

❒ *The Choice of a Package*

The negotiating principals have to determine the package. Any one of a number of genuine options exist, as was indicated in chapter 6. An outsider, a consultant, a messenger cannot make the choice for the negotiating principals, because they do not bear the fundamental and continuing responsibility.

We were asked to offer our own opinions, after engaging in our Consultations. In the hope that it might provide a useful starting point for the negotiations, we suggest a package that we believe to be attractive and attainable. Variants of this package could be considered for the teachers, the public servants, and perhaps for different groups of public servants.

❒ *The Package*

The package regarding governance, participation, responsibility, negotiability and collective bargaining could include the following. (The assumption is that the arrangement would be a fully-shared, self-sustaining risk/reward pension program.)

- A full partnership and joint trusteeship of the pension program, with responsibilities as set out under that heading in chapter 6.
- Equal representation by the participants and the government on the board of trustees. The sub-structure for policy and governance could ultimately be the responsibility of the board of trustees but an initial sub-structure of organizations, functions and representation might be agreed to in the initial negotiations. As suggested in chapter 6, this sub-structure would consist of an investment committee, a benefits committee, a contribution rate committee (or a combined benefits-contribution rate committee) and an administration committee.
- Pension matters negotiable between the negotiating principals but in ways that are consistent with the responsibility of the board of trustees.
- The legislation governing the pension programs be redrawn in more general terms, permitting changes in the programs by regulation and agreement.

- The negotiating principals must establish firm processes for periodic review of the fundamental soundness of the pension programs, usually acting on the reports of the boards of trustees, normally following triennial valuations. The "principals' review board", as we suggest it be called, would have the power to impose interim adjustment programs, as agreed to by this board's representative parties.

- Require annual interim updates of triennial valuations.

- Require the establishment of a deadlock-breaking mechanism for the board of trustees and the "principals' review board".

❐ *Elements of Attractive and Attainable Programs*

The following elements could make up attractive and attainable programs.

- Continue the defined benefit programs such as they now exist, together with the present indexing adjustment level.

- Create the conditions for successful mergers and merge the respective basic and inflation adjustment programs.

- The valuation, costing and determination of contribution rates should be done on a "best estimate/realistic" basis. The advice we have received suggests the real interest basis should be three per cent to 3.5 per cent. We believe that the negotiating principals should consider the upper rather than the lower part of that range.

- Design the programs using assumptions that incorporate modest cushions against adverse actuarial experience.

- Accept a "modest-risk - modest-earnings" target for the market portfolio of the investment funds. The advice we have received suggests that the real rate of return should be within the 3.5 per cent to four per cent range and closer to the upper than the lower part of the range.

- The risk/reward must be equally shared between the government and the participants as agreed. There is great attraction in sharing equally. We suggest that this be a starting point for the negotiations.

- Putting aside the costs of pension reform and any other benefit improvements, the outcome of this proposal would be normal joint contribution rates in the range of 17.8 per cent to 18.2 per cent of earnings for the teachers' program and 15.6 per cent to 16.0 per cent of earnings for the public servants' programs. This assumes that the longer-run normal contribution rates are to be set immediately. These rates are to be compared with the Coward report estimates, net of reform, of about 19.8 per cent of earnings for the teachers and 17.6 per cent of earnings for the public servants. The option of a gradual adjustment of contribution rates may also be considered by the parties.

In short, under our proposal we believe that there is a reasonable prospect of keeping the contribution rate increases to about one per cent each side, net of reform, retaining current benefit levels. Another effect of our proposal is a commitment to full funding of future service pension liabilities, including contractual indexing.

Indeed, the investment policy target could be a somewhat higher real rate of investment return than the "interest rate" used for valuing the programs and determining the contribution rates. If the targets are achieved, as we are told they should be in a well-managed program, the programs would tend to accumulate surpluses over the long run. The surpluses may average between one per cent and two per cent of earnings per year on average over the long term.

We recommend the establishment of a start-up fund and investment reserve fund for each program which would have at least one-half of the existing basic fund surpluses, as of the end of 1987, and 100 basis points of the high nominal investment earnings for the next five years placed in this fund. The combined start up and investment reserve funds under these proposals would be at least $400 million for the public servants' program and at least $825 million for the teachers' programs, both before funding pension reform.

The start-up and investment reserve funds could:

- Fund pension reform provisions. The cost to fund minimum reforms would be equivalent to about one per cent of earnings joint contribution rate for the public servants and 0.8 per cent for the teachers[1]. If these provisions are funded as of January, 1988, the lump sum funding requirement is approximately $350 million to $400 million for the teachers' program and approximately $250 million for the public servants' program.
- Establish an investment variation reserve policy. An initial contribution to fund such a policy could be made from the proposed start-up funds.
- Consider a portion of the start-up funds be used as a modest cushion of the necessary increases in the normal contribution rates.
- Fund any other high priority improvement in benefits.

We believe the negotiating principals should agree in principle to have an investment variation reserve fund as a continuing element of the future investment management of the programs. We feel this should be established in view of the increased short-term variability and volatility that will likely be incurred when the investments of the pension programs are transformed into a low- to moderate-risk market portfolio.

We feel that aside from the earmarking of certain assets or fund income for the start-up and investment variation reserve funds, all other assets of the respective funds should enter into the valuation on merging and would be taken into account in the determination of the unfunded liabilities.

We accept the general view that the government should accept the responsibility for the unfunded liability related to the SAFs and should enter into an amortization program over a period of 15 to 25 years.

If the pension deals that are agreed to are full risk/reward sharing in self-contained programs without government guarantees, we stress that it must be clear that the amortization program should not follow normal public and private pension amortization practices. The normal amortization program is appropriate to a pension deal in which the employer as sponsor has to make good all the funding and experience deficiencies and is entitled to all the surplus from favourable experience. The amortization program would then be adjusted after each formal filed valuation on the basis of performance.

Such an approach would be inappropriate for a fully shared, risk/reward pension program. The participants and the government would both expect to share the rewards of good performance on a reasonable timetable, just as they would have to share the burdens of unfavourable performance. Under such a shared risk/reward approach, the amortization of the initial unfunded liabilities might be established as an unconditional contract between the government and the funds, as suggested at the end of chapter 6.

[1] Figures are derived from the Coward report.

We believe that our recommended package, suggested as a beginning point for negotiation, is a balanced "middle-of-the-road" approach. We believe that:

- It recognizes that preserving existing benefits and making the improvements required by pension reform will require some increase in contribution rates.
- It takes into account reasonable expectations of long-run increases in investment earnings from diversified market portfolios.
- It recognizes that even a low-risk market investment program will introduce investment performance volatility and will require management involving the use of averaging and the use of an investment variation reserve fund. Such requirements will be even greater if a moderate or high risk/reward strategy is adopted.
- It accepts the developing trend of costing pension programs on the "best estimate" or "realistic" basis, and thus trades off lower contribution rates against higher safety margins.
- It provides a basis for funding pension reform.
- It provides a basis for cushioning the increases in contribution rates in the immediate future and introducing a program of gradual change, which may be adjusted as experience indicates the need. It thus recognizes the legitimate concern of members about large immediate increases.
- It puts the responsibility for the long-run health of the pension programs on a shared basis between the government and the pension plan members.
- It proposes that a portion of the current financial strength of the funds be used to meet transition problems and to place the financing of future benefits on a sound basis. The aim is to have a pension program that is capable of coping with contingencies without placing undue burdens on either the government or plan members.
- It proposes that much of the current financial strength of the funds be used as a contribution to reducing the unfunded liabilities related to the SAFs and thus reducing a small portion of what will be a heavy burden of amortization falling on the government.

SECTION V

❐ *Other Directions in Which The "Packages'" May Be Shaped in Negotiations*

The responsible parties to the negotiation of the new pension deals may wish to shape the "Package" in rather different ways, because of its high level of expense, or their sense of fairness, or their ability to sell it to the ultimate interested parties, namely, the members and the taxpayers. What follows is a check list of alternatives to consider in shaping the choice.

❐ *Checklist of Alternatives in Shaping Choice*

❐ **With Respect to Governance and Structure;**

The alternatives to Full Partnership and Joint Trusteeship are:

- Limited partnership
- Reform of existing arrangements

- **With Respect to the Pension Deal**

The directions for shaping the "Package" suggested above are:

- aim for more or less benefits, in the basic plan or the indexation, or withdrawal, or early retirement provisions, or some combination of benefits
- consider that, other things being equal, more benefits implies larger contribution rates and less benefits implies smaller contribution rates

Increase or Decrease the Actuarial Safety Margins

- other things being equal, increased safety margins increase contribution rates in immediate prospects, and increase potentialities for surpluses in the long run

Base the contribution rates on less or more risky "real interest rate" assumptions

- The use of less risky "real rates" implies the requirement for larger contribution rates if other items which impact on pension costs are unchanged.

Increase or decrease the reward targets for the investment policy

- Such choices in reward targets increase or decrease the risk and volatility, increase or decrease the problems of managing variability and thus the possibility of having to make periodic changes in contribution rates or benefits.

To Include or not to include ethical and social considerations in investment objectives

Earmark smaller or larger contributions to start-up fund

- The more that is allocated to the start-up fund, the larger the unfunded liabilities and the amortization requirements. Conversely the less that is allocated, the smaller will be the liabilities and requirements.
- If there is no earmarking of start-up funds, pension reform and other pension improvements will have to be met through higher contribution rates. If initial investment experience is disappointing, contribution rates may have to be increased or benefits reduced to achieve funding goals.

Choose a different set of priorities for the use of the earmarked start-up fund

- We have suggested financing of pension reform and making an initial contribution to the investment variation program as top priorities, but the interested parties may have different rankings and other objectives

Impose a little or a lot of the burden of the unfunded liabilities on the current and future contributors to the pension programs.

- We have suggested that the unfunded liabilities should be amortized and paid by the government through an unconditional amortization commitment.

SECTION VI

Teachers' Pension Programs

While there are common elements in both the teachers' and public servants' pension programs, there are also important differences. Both the pace and form of the development of new pension programs may differ between the two groups because of their different needs.

It is our view that with the necessary will on the part of both negotiating principals, that the teachers and government should be able to agree to a satisfactory program within the next 12 months. This should be a less complex process than for the public servants because teachers are fairly homogeneous in their career paths, preferences for retirement income and related benefits, and in their long service patterns. The teachers' federations have long experience in and extensive knowledge of pension matters. The Ontario Teachers' Federation has many years of experience in the negotiation of pension matters with the government and with their constituencies, as well as in pension administration.

We do not know what the OTF want in pension benefit improvements, nor should we necessarily be so informed. From the long record on these matters and from our discussions we believe that some benefit improvements are sought. Some formal changes will be required to deal with pension reform. The negotiating process will have to be concerned with these issues of improved benefits in some orderly way, as well as the larger issues of trusteeship, investment policy, merging, past service unfunded liabilities and contribution rates.

While many of the conditions for agreeing quickly to a comprehensive and definitive new pension program with teachers are favourable, a number of difficult considerations may limit the range of such a deal and the speed of achieving it. They are:

- There is much disagreement between the government and the teachers concerning the facts of the teachers' pension programs and the interpretations of the facts. This is most evident in the areas of investment returns and in the calculation of contribution rates.
- Whether it is important to the government and the public that pension matters for teachers be viewed within a total compensation framework, even if only in a general way, Some method will have to be found to impress the pension elements of compensation on the minds of local school boards and local teachers organizations.
- Teachers' organizations appear to have somewhat optimistic notions of how large and how quickly pension investment diversification will result in increases in pension fund earnings.
- Some representatives of the teachers feel that the risk-bearing capacity of the government is much greater than the collective and individual risk-bearing capacity of the plan members. This belief may lead to a continued desire by teachers to keep the government guarantee, or to find some other way for the government to carry most of the risk.
- Teachers may feel that not enough weight is being given to the use of surpluses in the TSF for benefit improvements, quite apart from pension reform.
- Teachers may feel we have proposed that too great a portion of the high streamed investment earnings be used to reduce the TSAF unfunded liabilities. The government may feel we have recommended that too little of these earnings be used to reduce the unfunded liabilities.

SECTION VII

❐ *Public Servants' Pension Programs*

Members of the public service are much more heterogeneous than the teachers. The range of pay and working conditions is much broader and career paths vary greatly. Turnover is much greater. A substantial minority of the employee groups covered by the public service plan are not unionized. Unionized employees are split among a number of unions who may not always reflect the same constituencies needs and preferences. The unions vary greatly in their experience in and knowledge of pension matters.

For these reasons, it may be a much more complex process to work out an attractive package quickly for all or particular segments of the public service than it will be for the teachers.

Because of the issue of greater complexity, the question arises as to the contents for a more limited start-up package with the public service. This start-up package would be put together with the establishment of a process for learning, future negotiation and adjustment.

A start-up new package might involve:

- Agreement to establish joint trusteeship; pension programs to be at arm's length to the government.
- Agreement that pension matters become negotiable.
- Agreement for start-up purposes to preserve existing benefits; to make those required by pension reform; to negotiate benefit improvements for those participants least well supported by the existing pension program.
- Agreement that pension funds are to be invested in diversified market portfolios.
- Agreement on the establishment of a joint task force with jointly acceptable expert advisers to make recommendations on the fundamental features of the future pension arrangements.
- Agreement that the public sector pension programs will be explicitly seen in the context of total compensation.
- Agreement that as an interim measure contribution rates be increased by, say, one per cent of earnings on each side.
- Agreement that if it is necessary, a schedule of further increases in normal contribution rates of 0.1 per cent of earnings for each side over a 10 year period be authorized. Further agree to develop a strong monitoring and review process to abort, to reduce or to extend these adjustments based on plan performance.
- Agreement to consider the division of the public servants' pension program into two or more separate programs to meet different employee constituencies.
- Agreement to establish an arbitrary earmarked start-up fund for some or all of the purposes set out above. Agreement to provide for the review and modification of the start-up fund depending on need and experience.
- Agreement in principle to merging the basic fund and the relevant indexation funds, aside from the arbitrary earmarked start-up fund, and agreement to determine the unfunded liabilities on a merged basis.
- Agreement to a date for termination of the government guarantee.
- Agreement that the government will assume the unfunded liabilities.
- Agreement that the funding of any future unfunded liabilities will be shared between the government and the members of the programs.

The fundamental difference between the prospective new programs for the teachers and the public servants is that, in the latter case, those agreements which are immediately pending may have to be less definitive and less comprehensive. But if this is so, the processes for learning and adjusting to attain good, efficient, and secure future pensions for the public servants may have to be even stronger than for the future teachers' program. However, in the case of the public servants, the issues of dealing with pensions in a total compensation framework may be a good deal easier than in case of the teachers.

SECTION VIII

❐ *Afterword*

In addition to acceptance by the government of its obligation regarding the unfunded liabilities, the central point of the package which we have suggested as a basis for negotiation is that the pension program would assume a modest degree of risk in costing the plans, in safety margins and in investment policy.

The investment risk that we have recommended is comparable to what is accepted by large well-run private and other public sector programs.

Because the benefits proposed are somewhat larger than those in other public sector pensions programs and because of the differences in membership demographics, it is expected that the contribution rates for the teachers' and public servants' programs may have to average marginally above those of other public sector programs indefinitely into the future, even with successful investment performance. But they could still be good value for the money.

We believe our suggested package as a starting point for negotiation is attractive, attainable, responsible and fair.

- The teachers and public servants would have increased responsibility for their pensions.
- The opportunity is created for more favourable long-term investment rewards. This is compatible with the acceptance, management and sharing of moderate degrees of risk. There is a long-run prospect of some combination of better pensions and contribution rates.
- Processes are improved for monitoring and changing pension programs as circumstances permit or preferences alter.
- Our proposal provides for start-up, transitional and investment reserve features that can furnish a credible inauguration of the new pension program.
- The favourable investment earnings of recent years are shared between benefits to current members and the reduction of the SAF unfunded liabilities.
- Pension reform is funded and unfunded liabilities are paid in an orderly way.
- The future risk/reward sharing between the participants and the government can commence immediately upon agreement of the negotiating principals.

From the point of view of the taxpayers and the government, we believe the package is a reasonable one. Any solution to the teachers' and public servants' pension problems will inevitably affect taxpayers. Our proposed package has the following attractions to the taxpayers and the government:

- The responsibility for the pension programs is shared equally between the government and teachers and public servants.
- The pension programs are placed more firmly, openly and explicitly in a total compensation framework.
- Through risk/reward sharing, the one-sided government responsibility for deficiencies is replaced.

- The adoption of a moderate investment risk target is supported and allows for the government and plan members to share in the rewards.
- The proposal may make the government guarantee unnecessary.
- The pension programs are placed on a sound and vigorous basis for the future.
- The likelihood for experience deficiencies such as those that arose in the 1970s is reduced.

Our proposed package does involve an unavoidable and significant commitment by the government to pay the unfunded liabilities over 15 or 25 years. The income and tax base of the province will increase substantially over the next 15 to 25 years and the unfunded liability payments could be scheduled in step with that growth. Whatever choice is made in this regard, the arrangements to pay the unfunded liabilities must be definite and adequate.

Making a fresh start is now in the hands of the pension plan principals and it is up to the negotiating parties to determine what form the future pension programs will take. Good benefits for reasonable cost are obtainable. We are confident that all of the issues under consideration can be resolved satisfactorily with the necessary will, trust and cooperation of the government and pension plan members.

LIST OF APPENDICES

A. Terms of Reference

B. List of Organizations and Individuals Submitting Briefs

C. List of Visits We Initiated

D. Consultations Seminar: Program and List of Participants

E. Interest Rates on the TSF/TSAF and PSSF/PSSAF

APPENDIX A

TERMS OF REFERENCE (Order in Council O.C. 431/88)
February 18, 1988

On the recommendation of the undersigned, the Lieutenant Governor, by and with the advice and concurrence of the Executive Council, orders that

WHEREAS the Treasurer of Ontario and Minister of Economics has retained Laurence Coward to prepare a report to the Treasurer on issues relating to the financing of indexed pensions under the Public Service Superannuation Act, the Teachers' Superannuation Act and the Superannuation Adjustment Benefits Act;

AND WHEREAS Malcolm Rowan has been requested to prepare a report to the Treasurer of Ontario and Minister of Economics on the investment of Public Sector Pension Funds;

AND WHEREAS a working group has been established under the chairmanship of Professor Martin Friedland to inquire into and report on the most appropriate formula and phase-in procedures for inflation protection for employment pension plans;

AND WHEREAS all of the aforesaid reports have been received and made public.

AND WHEREAS it is in the public interest to provide a forum where the conclusions and recommendations arising from these several reports can be commented on by interested members of the public, and can be reviewed to identify an appropriate course of action that will reflect the essential elements of the recommendations made in the reports;

THEREFORE, commencing the 11th day of February, 1988, Dr. David Slater is hereby authorized to conduct consultations and report to the Treasurer of Ontario and Minister of Economics, Chairman of the Management Board of Cabinet and the Minister of Education with respect to the following matters:

(a) The advantages and disadvantages of fully funding adjustment benefits payable from the Superannuation Adjustment Funds and, if full funding is recommended, the methods of financing unfunded liabilities and of establishing contribution rates.

(b) The desirability of merging the respective Superannuation Adjustment Funds with the Public Service Superannuation Fund, the Teachers' Superannuation Fund and the Retirement Pension Plan of Ryerson Polytechnical Institute.

(c) The appropriate future direction for changes in pension plan design, if required, and the method for adjusting contribution rates.

(d) The potential benefits and concerns with respect to investing these pension funds in marketable securities, including the impact on contribution rates, and if such investments are considered appropriate, guidelines as to their administration.

(e) Whether these pension funds should be established separately and at arm's length from the government as pension sponsor.

AND THAT in the preparation of his report, Dr. Slater shall, to the extent that he finds it practical to do so:

(1) Synthesize the findings and recommendations of the Rowan, Coward and Friedland reports.

(2) Solicit written briefs from all interested parties in the public and private sector and hold meetings as required.

(3) Provide a forum for discussion between groups with different views on the various issues of fact and opinion.

(4) Resolve, where possible, differences in the assumptions made or taken into account in the reports that he is considering.

AND THAT Dr. Slater shall provide in his report a summary of the views expressed to him by the public on the issues raised in the reports he is considering, and shall provide his own views and recommendations with respect to the issues on which he is authorized to report;

AND THAT the report hereby authorized shall be delivered in writing on or before the 31st day of July, 1988.

APPENDIX B

List of Organizations and Individuals Submitting Briefs

Individual Teachers, Public Servants, Retired Teachers, Retired Public Servants and Members of the General Public

Cathy Bachner
St. Mary's, Ontario

John G. Brown
Etobicoke, Ontario

Ron Brown
London, Ontario

George Buckrell
Leamington, Ontario

Art J. Campbell
Nepean, Ontario

Roy A. Chittick
Islington, Ontario

James Finlayson Coull
Scarbourough, Ontario

T.A. Crosby
Port Hope, Ontario

John Dyke
Cambridge, Ontario

William Eby
Barrie, Ontario

George F. Forler
Barrie, Ontario

Margaret Furlong
Windsor, Ontario

Michael Furlong
Windsor, Ontario

F.A. Furlong
Windsor, Ontario

Bryan B. Gollop
Port Perry, Ontario

Mervyn Hanna and Hildegard Martens
Toronto, Ontario

Mary Jane Hudasek
Bracebridge, Ontario

Leonard J. Hudyma
Willowdale, Ontario

N.R. Ingram
Bruce Mines, Ontario

Ernest Jackiw
Kingsville,Ontario
on behalf of 60 teachers from Kingstonville
District High School

William A. Jordon
Brampton, Ontario

Gretchen B. Jordan
Brampton, Ontario

Heather Keast
Stratford, Ontario

David Kelly
Guelph, Ontario

S. Khan
Oshawa, Ontario

H.J. Kientopp
Leamington,Ontario
on behalf of 100 teachers from Leamington
District Secondary School

Paul Kirkup
Penetang, Ontario

Florent Lalonde
Welland, Ontario

Claude LeBlanc
Colborne, Ontario

Roger Lenney
Islington, Ontario

L.D. Maisonville
Queensville, Ontario

Kenneth H. Mason
London Ontario

S.L. McFadden
Elk Lake, Ontario

A.T. McQueen
Toronto, Ontario

Corine Menton
Aurora, Ontario

Bess E. Moore
Athens, Ontario

Jack L. Neale
Tillsonburg, Ontario

N.P. Nicolson
Sault Ste. Marie, Ontario

Elsie Parish
St. Thomas, Ontario

W. A. Parish
Ajax, Ontario

David C. Parrott
Lindsay, Ontario

A. K. Ray
Gloucester, Ontario

David Rowe
Willowdale, Ontario

G. K. Schultz
Bracebridge, Ontario

Marjorie Scime
Dundas, Ontario

Gertrude M. Scott
Toronto, Ontario

R. Edgar Scrutten
Amherstburg, Ontario

R. G. Skinner
Willowdale, Ontario

Norman H. Sloane
Sault Ste. Marie, Ontario

Aileen Stephenson
Toronto, Ontario

H. Paul Sutton
Toronto, Ontario

William Thibedeau
Toronto, Ontario

Robert J. Thomlinson
Sault Ste. Marie, Ontario

John White
Oshawa, Ontario

M.J. Wilkin
Windsor, Ontario

Ralph S. Winslade
Vineland Station, Ontario

Earl J. Wood
Lindsay, Ontario

Jack Wyatt
Kingston, Ontario

Walter W. Zessner
Toronto, Ontario

Ann M. Ziemann
Etobicoke, Ontario

Unions and Professional Associations and Employee Organizations

Ontario Public Service Employees' Union (OPSEU)
Toronto, Ontario

Ontario Teachers' Federation (OTF)
Toronto, Ontario

Ontario Provincial Police Association (OPPA)
Barrie, Ontario

Ontario Federation of Labour (OFL)
Don Mills, Ontario

Ontario Secondary School Teachers' Federation (OSSTF)
Toronto, Ontario

Canadian Union of Public Employees (CUPE)
Toronto, Ontario

Management Employees' Group (MEG)
Ministry of Transportation
Downsview, Ontario

Civil Lawyers' Association
Toronto, Ontario

Ontario Secondary School Teachers' Federation, District 1
Windsor, Ontario

Ontario Secondary School Teachers' Federation, District 2
Aurora, Ontario

Ontario Secondary School Teachers' Federation, District 18
Peterborough, Ontario

Ontario Public Service Employees' Union, Local 309
Lindsay, Ontario

Ontario Public Service Employees' Union, Local 515
Toronto, Ontario

Canadian Union of Public Employes, Local 79
Toronto, Ontario

Superannuated Teachers' of Ontario, District 3
Sault Ste. Marie, Ontario

Superannuated Teachers' of Ontario, District 13
Hamilton, Ontario

Superannuated Teachers' of Ontario, District 16
Toronto, Ontario

Superannuated Teachers' of Ontario, District 36
Best Five Committee
Peterborough, Ontario

Toronto Civic Pensioners' Protective Association
Toronto, Ontario

Advisors, Professional Groups and Service Vendors

The Association of Canadian Pension Managment
Toronto, Ontario

The Canadian Bankers' Association
Toronto, Ontario

The Candian Chamber of Commerce
Ottawa, Ontario

The Ontario Chamber of Commerce
Toronto, Ontario

McLeod Young Weir Limited
Toronto, Ontario

Midland Doherty Limited
Toronto, Ontario

Teachers' Money Matters
Thornhill, Ontario

Toronto Stock Exchange
Toronto, Ontario

Sponsors and Administrators

Teachers' Superannuation Commission
Willowdale, Ontario

Other Interested Parties

President
Ontario Public School Trustees, Assoc.
Toronto, Ontario

Director, Human Resources
Ryerson Polytechnical Institute

Task Force on the Churches and Corporate Responsibility
Toronto, Ontario

National Citizen's Coalition
Toronto, Ontario

APPENDIX C

List of Visits We Initiated

Peter Hirst
President
Actrex Partners Limited

Bill Allen
President
Allenvest Group Limited

Fleming Armstrong
Chief Financial Officer
Allenvest Group Limited

Andrea Vincent
President
Association of Canadian Pension Management

J.N. Ross Wilson
Deputy Governor
Bank of Canada

Carl Wostenholme
Director
Burns Fry Limited

Peter G. Rusheleau
Government Services
Burns Fry Limited

Robert MacIntosh
President
Canadian Bankers' Association

Judith Andrews
Director, Provincial Affairs of Ontario
Canadian Federation of Independent Business

Jim Bennett
Vice-President, Legislative Affairs
Canadian Federation of Independent Business

Michael Spengemann
Senior Vice-President
Investment Management
Canadian Imperial Bank of Commerce

Donald Armstrong
Consultant
The Wyatt Company representing the
Canadian Institute of Actuaries

David Short
Consultant
Eckler Partners representing the
Canadian Institute of Actuaries

David Sloan
Treasurer
Canadian Pacific Limited

Jack MacDonald
President, Local 1000
Chairman, Ontario Division
Pension Committee
Canadian Union of Public Employees

Margot Young
Research Officer
Canadian Union of Public Employees

David W. Conklin
President
Conklin and Associates Inc.

Donald C. Moors
The Coopers & Lybrand Consulting Group

H.B. William Johnston
National Pensions Co-ordinator
Deloitte Haskins+Sells

Robert H. Field
Chief Executive Officer
Education Relations Commission

Sharon McAlroy
Director, Information Services
Education Relations Commission

Don Ezra
Director
Frank Russell Canada Ltd.

John B. Sanders
Hewitt Associates

Robert J. McKay
Hewitt Associates

Andrew M. Bucknall
General Manager
Hospital of Ontario Pension Plan Ontario Hospital Association

David C. Toms
General Manager, Investments
Hospital of Ontario Pension Plan Ontario Hospital Association

Dr. Elaine Todres
Deputy Minister
Human Resources Secretariat

Jim Thomas
Assistant Deputy Minister
Human Resources Secretariat

Bill Rooke
Director, Benefits Policy Branch
Human Resources Secretariat

Bob Buck
Director, Actuarial Services
Human Resources Secretariat

Michael S.F. How
Vice-President & Partner
Integra Capital Management Corporation

Graham S. Rennie
President & Managing Partner
Integra Capital Management Corporation

Keith P. Ambachtsheer
Keith P. Ambachtsheer & Associates Inc.

Milt Harmelink
Chairperson of Senior Council
Management Employee Group Senior Council

Michael Biggar
Senior Analyst Budgetary, Devel. Sect.
Management Employee Group Senior Council

Norm McKinnon
Co-ordinator
Management Employee Group Senior Council

Jalynn Bennett
Vice-President, Corporate Affairs
Manufacturers' Life Insurance Co.

M.J. Ferrara
Vice-President & Director
McLeod Young Weir

David J. Adamo
Vice-President, Economist
McLeod Young Weir

Robert McDermott
Partner
McMillan Binch Barristers

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Institutional Equity Division
Midland Doherty Limited

Robert F. Kay
Vice-President & Director, Public Finance Dept.
Midland Doherty Limited

Robert G. Boaz
Vice-President & Chief Economist
Midland Doherty Limited

James D. Donegan
Senior Economist
Midland Doherty Limited

Bernard J. Shapiro
Deputy Minister
Ministry of Education

Mark Larratt-Smith
Assistant Deputy Minister
Corporate Planning and Policy Division
Ministry of Education

Cathy Suiten
Chairman Trustee
Ministry of Education

Katherine Smith
Director, Corporate Planning and
Financial Management Branch
Ministry of Education

Janet Skelton
Manager
Teachers' Superannuation Unit
Ministry of Education

Wendy Gauthier
Senior Policy Advisor
Teachers' Superannuation Unit
Ministry of Treasury & Economics

Mary Mogford
Deputy Treasurer
Ministry of Teasury & Economics

Michael L. Gourley
Assistant Deputy Minister
Ministry of Teasury & Economics

Kathy Bouey
Director, Intergov't Finance Policy Br.
Ministry of Teasury & Economics

Bruce Macnaughton
Manager, Social Policy
Ministry of Treasury & Economics

Robert D. Christie
Director, Finance Policy Branch
Ministry of Treasury & Economics

Wendy Tysall
Assistant Director
Financial Control & Reporting
Ministry of Treasury & Economics

Phyllis M. Clark
Assistant Director, Finance Policy Br.
Ministry of Treasury & Economics

Al Reeve
Executive Director
OMERS

Gordon Wilson
President
Ontario Federation of Labour

John A. O'Grady
Legislative Director
Ontario Federation of Labour

Peter M. de Auer
Director, Pension Fund
Ontario Hydro

John Cook
Manager, Investment Strategy
Ontario Hydro

R.K. Moorthy
Director, Comp. Policy & Benefits
Ontario Hydro

Larry Leonoff
General Counsel & Secretary
Ontario Hydro

Eric R. Preston
Manager, Benefits & Compensation
Ontario Hydro

Roy Rastrick, representing the
Ontario Liquor Board Employees Union

Bob Hunter
Executive Director
Ontario Provincial Police Association

Jim Kingston
Executive Manager
Ontario Provincial Police Association

Bill Hutton
Ontario Provincial Police Association

Larry Strange
Director
Ontario Provincial Police Association

Grant Scharf
Director
Ontario Provincial Police Association

John Jacobs
Executive Director
Ontario Public School Trustees' Association

Fred Upshaw
Acting President
Ontario Public Service Employees Union

Ron Martin
Acting Vice-President
Ontario Public Service Employees Union

Pauline Seville
Executive Assistant to the President
Ontario Public Service Employees Union

Lillian Stevens
Co-ordinator, Membership Benefits
Ontario Public Service Employees Union

Andy Todd
Co-ordinator, Collective Bargaining
Ontario Public Service Employees Union

Ralph Connor
Ontario Seconday School Teachers' Federation

Ron Harris
Ontario Secondary School Teachers' Federation

Sal Pengelley
Ontario Secondary School Teachers' Federation

John Fauteux
President
Ontario Teachers' Federation

David Aylsworth
Executive Assistant
Ontario Teachers' Federation

Margaret Wilson
Secretary-Treasurer
Ontario Teachers' Federation

Randall J. Dutka
Partner, Actuarial & Benefits
Peat Marwick

John Kruger
Chairman
Pension Commission of Ontario

Robert Hawkes
Superintendent
Pension Commission of Ontario

Tian-Teck Go
Actuary
Pension Commission of Ontario

John W. Kellett
Vice-President
Corporate & Pension Fund Investments
the Royal Bank of Canada representing
Pension Investment Association of Canada

Watson Ogilvie
Chairman
Pension Investment Association of Canada

Victor Alboini
President & Chief Operating Officier
Prenor Financial Ltd.

Peter Spark
Senior Vice-President & Director
Bolton Tremblay Inc. on behalf of
Prenor Financial Ltd.

Elizabeth Aboud
Private Citizen

Rollie Scott
Private Citizen

Ethel McLellan
Chairman
Public Sector Pensions Advisory Board

Richard Lundeen
Executive Director
Public Sector Pensions Advisory Board

Sherry Malloy
Senior Pensions Advisor
Public Sector Pensions Advisory Board

Lee Bentley
Vice-Chairman, Investment Services
Royal Trust

Michael A. Belfie
Senior Associate, Product Development
Royal Trust

Angelo Pesce
Director, Human Resources
Ryerson Polytechnical Institute

Dr. Frank Abbott
Ryerson Polytechnical Institute

Arie Reedyk
Ryerson Polytechnical Institute

Douglas Grant
Chairman of the Board
Chief Executive Officer
Sceptre Investment Counsel Limited

Bill Saunderson
Vice-President & Secretary-Treasurer
Sceptre Investment Counsel Limited

George Turnbull
Vice-President
Sceptre Investment Counsel Limited

Yves Guerard
Sobeco

Don Walcot
President, SUNIMCO
Sun Life Canada

Steve Brown
Vice-President, Investments
Sun Life Canada

Sarah Clodman
Manager, Gov't & Industry Relations
Sun Life Canada

Peter Honey
Chairman
Teachers' Superannuation Commission

Dan McArthur
Director
Teachers' Superannuation Commission

Bill Foster
Director, Communication & Info. Serv.
Teachers' Superannuation Commission

Al McKellar
Director, Comm. & Entitlement Division
Teachers' Superannuation Commission

G.M. Break
General Manager of Operations
Toronto Transit Commission

Herb Jobb
General Manager
Toronto Transit Commission

Charlie Johnson
President, Local 113
Toronto Transit Commission

John D. Cannell
Manager, Pension Fund Society
Toronto Transit Commission

Robin Pond
Senior Administrative Pension
Fund Society
Toronto Transit Commission

Shiraz Bharmal
Director
Towers, Perrin, Forster & Crosby

H. Douglas Lee
Vice-President
Towers, Perrin, Forster & Crosby

Tristram S. Lett
President
Trafalgar Capital Manangement

Don Lee
President
Union Pension Service Ltd.

Professor James E. Pesando
Director
Institute for Policy Analysis
University of Toronto

Laurence E. Coward
Director Emeritus
William M. Mercer Limited

David B. Meynell
Principal
William M. Mercer Limited

Donald V. Fowke
Principal
William M. Mercer Limited

John Ilkiw
Principal
William M. Mercer Limited

David Stouffer
Principal
William M. Mercer Limited

George E. Buckley
Vice-President
Wood Gundy Inc.

APPENDIX D

Consultations Seminar: Program and List of Participants

Seminar Program: Niagara Institute, Niagara-on-the-Lake
May 19 - 20, 1988

Seminar Program

Thursday, May 19

Seminar Overview - Dr. David Slater

Morning Moderator: Margaret Wilson

A. Future Benefit Program		
	Discussants:	Michael Belfie
B. Factors Affecting Costs		
1. Funding: Partial or Full Funding		
	Discussants:	John O'Grady, OFL Laurence Coward
2. Indexing		
	Discussant:	David Conklin
3. Risk/Reward		
Real Rates of return		
	Discussant:	James Pesando
Actuarial assumptions vs financial perspectives		
	Discussant:	Keith Ambachtsheer

Afternoon Moderator: David Conklin

Post-luncheon speaker: Naomi Alboim, Assistant Deputy Minister, Ontario Women's Directorate
"Pensions in a comprehensive compensation framework: Integrating Work and Family Life"

C. Cost Sharing Options		
	Discussants:	Margaret Wilson, OTF Shiraz Bharmal
	Remarks	Malcolm Rowan
D. Governance/Structure Section		
1. Fund Investment		
	Discussants	David Meynell Fleming Armstrong

Friday, May 20

Morning Moderator: Peter Hirst

D. Governance/Structure Section		
2. Benefits Policy		
	Discussants:	Ron Martin, OPSEU Angelo Pesce
3. Models of Governance		
	Discussants:	Herb Jobb
4. Legislative Framework		
	Discussant:	Randy Dutka
Rapporteur and Moderator		David Slater
"The Last Word"		All participants

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APPENDIX E

❒ *Earned Rates of Return on Book Value for the TSF, PSSF and SAF*

CALENDAR YEAR	TSF	PSSF	SAF
1966	4.70	5.00	-
1967	4.72	5.00	-
1968	4.80	5.00	-
1969	4.74	5.00	-
1970	4.69	5.00	-
1971	5.65	5.78	-
1972	6.48	6.00	-
1973	6.76	6.25	-
1974	6.95	6.53	-
1975	7.28	6.97	-
1976	7.60	7.46	10.18
1977	7.97	7.87	9.79
1978	8.35	8.13	9.53
1979	8.55	8.40	9.60
1980	8.77	8.74	10.03
1981	9.16	9.31	10.35
1982	9.80	10.08	12.28
1983	10.68	10.55	13.00
1984	11.05	10.88	13.01
1985	11.28	11.18	13.00
Average Return (Geometric)			
20 Year	7.48	7.44	-
10 Year	9.32	9.25	11.07
5 Year	10.39	10.40	12.32
Standard Deviation			
20 Year	2.15	2.07	-
10 Year	1.25	1.18	1.46
5 Year	0.80	0.66	1.03
Sharpe Risk/Return Measure			
20 Year	-0.4106	-0.4449	-
10 Year	-1.3781	-1.506	0.0254
5 Year	-2.1252	-2.676	0.2363

Source: *Ministry of Treasury and Economics, 1987.*

❒ *Interest Rates on New Cash Flows for the SAF, PSSF and TSF Interest Rates*

FISCAL YEAR	TSF	PSSF	SAF (B)
1971-72	8.57	6.00	-
1972-73	7.86	8.06	-
1973-74	8.06	8.39	-
1974-75	8.39	10.04	-
1975-76	10.04	10.11	10.18
1976-77	10.11	9.82	9.61
1977-78	9.82	9.51	9.23
1978-79	9.51	9.83	9.90
1979-80	9.83	11.05	11.44
1980-81	11.05	13.34	13.21
1981-82	13.34	15.38	16.90
1982-83	15.38	12.80	14.57
1983-84	12.88	12.88	12.59
1984-85	13.20 **(A)**	13.33	13.09
1985-86	11.45 **(A)**	11.55	11.04
1986-87	10.37 **(A)**	10.38	9.47
1987-88	11.13 **(A)**	11.10	10.40

(A) *Weighted average of the monthly rates*

(B) *Weight average of the interest rate chosen on the TSAF, PSSAF*

Source: *Ministry of Treasury and Economics, 1987*

GLOSSARY

The Consultations has made every effort to define and explain terms used in its report as they occur. This Glossary explains a number of specialized words and phrases.

In part, the Glossary has been adapted from the Report of the Task Force on the Investment of Public Sector Pension Funds, 1987 (Rowan Report).

ACCRUAL - The recognition of change in either assets or liabilities which has transpired over a period of time but which did not involve an explicit cash transaction.

ACTUARIAL ASSUMPTIONS - The assumptions actuaries adopt about future experience in order to estimate the future cost of pension benefits, including assumptions as to mortality rate, employee turnover, compensation levels and investment earnings.

ACTUARIAL SURPLUS - An actuarial surplus is the surplus that results from actual experience being better than what the actuary assumed.

ACTUARIAL VALUATION - The periodic estimation or valuation by an actuary of the present value of future benefits to be paid under a pension plan and of the assets held by the pension fund. On the basis of the difference between these two amounts, the actuary may recommend changes in the contribution rate.

ACTUARY - A professionally-trained specialist in the pension and insurance fields. In Canada, full professional recognition requires membership in the Canadian Institute of Actuaries.

AD HOC ADJUSTMENT - Amount added to a pension after retirement, on an irregular basis and not as a result of a prior commitment or contract. To be distinguished from indexing.

ASSET MIX - The mix of assets refers to the proportions of various types of investments held by a pension fund, usually expressed as the percentage of investments held in bonds, equities, real estate, etc.

ASSETS - The investments or cash held by a pension fund. These investments include equities and bonds traded on the capital markets, mortgages, real estate, venture capital, non-market government debt and private placements.

BENEFICIARY - In respect of a trust fund, the person(s) in whose interest the trust is established and who is (are) to benefit from it. Also used to refer specifically to a person who, on the death of a plan member or pensioner, may become entitled to a benefit under a pension plan.

BENEFIT - Generally, any form of payment to which a person may become entitled under the terms of a pension plan; often refers specifically to the normal pension provided by the plan benefit formula.

BENEFIT FORMULA - Provision in a pension plan for calculating a member's defined benefit according to years of service, earnings (career or final average), a fixed dollar amount, etc.

BEST EARNINGS FORMULA - A defined benefit formula which applies the unit of benefit credit for each year of service to the member's average earnings for a specified period of highest earnings (e.g., best five of the last 10 years of service).

BOND - A certificate to show evidence of debt. The term usually implies that specific assets have been pledged as security.

BOOK VALUE - The amount shown in the books as the cost of an asset. Usually refers to the price paid for an asset.

CANADA PENSION PLAN (CPP) - A national mandatory, earnings-related pension plan, introduced together with the Quebec Pension Plan (QPP) in 1965, for all working Canadians between the ages of 18 and 70. It is financed on a partial pay-as-you-go basis with only a small asset base relative to future liabilities.

CAREER AVERAGE FORMULA - A defined benefit formula that applies the unit of benefit to earnings of the member in each year of service, and not to final or final average earnings.

CASH FLOW - The total flow of funds in a given period. Calculated in the following manner: cash inflows (contributions and interest) minus cash outflows (benefit payments and operating expenses) = cash flow.

CASH OR NEAR CASH - Those pension assets held in cash or in assets such as treasury bills or short-term deposits, that can be converted to cash quickly.

COMMUTED VALUE - The value calculated in a prescribed manner and as of a fixed date of a pension, a deferred pension, a pension benefit or an ancillary benefit.

CONTRIBUTORY PLAN - A pension plan that requires the employees to make contributions by payroll deduction in order to qualify for benefits under the plan.

DEBENTURE - A form of long-term debt that is not secured by the pledge of specific assets.

DEFICIT - An amount determined by an actuary when the present value of estimated future pension liabilities is more than current assets. A deficit can arise from:

- past service liability, which usually occurs when the plan benefits are improved; or
- an experience deficiency, which can arise when actual experience differs from the actuarial assumptions.

(See also Experience Deficiency and Unfunded Liability)

DEFINED BENEFIT PLAN - A plan which defines the pension to be provided (based on service, average earnings, etc.) but not the total contributions. If the plan is contributory, the rate of employee contributions may be specified, with the employer paying the balance of cost. To be distinguished from defined benefit plan.

DEFINED CONTRIBUTION (MONEY PURCHASE) PLAN - Plan that defines contributions to be made by employer and employees, but not the benefit formula. Accumulated contributions and interest are used to purchase an annuity for the member (i.e: the pension is asset related). To be distinguished from defined benefit plan.

ECONOMIC ENHANCEMENT - A positive impact on the economy due to the investment of pension funds. There are various specific methods advocated for achieving this, such as:

- investing through the capital markets, achieving economic benefits as a secondary objective to a primary rate of return goal
- deliberately conferring a subsidy (through a lower rate of return) on investments which are judged to contribute to economic enhancement.

EMPLOYER/SPONSORED PENSION PLAN - A pension plan offered by an employer or supported by a group of employers for the benefit of employees.

EQUITY - A form of investment which involves ownership (e.g.: stocks, real estate, venture capital).

EXPERIENCE DEFICIENCY - An unfunded liability, revealed by an actuarial review of a pension plan, resulting from a difference between actual experience (investment earnings, salary levels, etc.) and assumptions made at the time of a previous valuation.

EXPERIENCE GAINS AND LOSSES (ACTUARIAL GAINS AND LOSSES) - Deviations between actual experience up to the valuation date and the actuarial assumptions previously used. Such deviations result in experience gains when actual experience is more favourable than that previously assumed or experience losses when actual experience is less favourable than that previously assumed.

FINAL EARNINGS FORMULA - A defined benefit formula which applies the unit of benefit credited for each year of service to the member's final salary rate or annual earnings immediately before retirement. A form of Best Earnings Formula.

FLAT BENEFIT FORMULA - A defined benefit formula which specifies a dollar amount of pension to be credited for each year of service.

FULLY FUNDED - Term describing a plan which, at a given time, has sufficient assets to provide for all pensions and other benefits in respect of service up to that date.

FUNDING - Systematic employer and/or employee contributions into a pension fund which, with investment earnings, are expected to provide for all pensions and other benefits as they become payable.

GOING CONCERN BASIS - Refers to the assumption, when making an actuarial valuation, that the pension plan will continue in operation indefinitely. (Opposite of plan termination or wind-up basis.)

HYBRID - A type of pension plan which promises a pension benefit equal to the greater of:

- a minimum guaranteed pension benefit
- employee and employer contributions plus investment earnings.

IMPUTED MARKET VALUE - The computed value of a non-market asset, based on the yield of a similar asset that is traded in the marketplace.

INDEXING - Provision for periodically adjusting a benefit amount (usually after retirement) according to a formula based on a recognized index of price or wage levels, e.g., the Consumer Price Index or on some other basis. To be distinguished from ad hoc adjustment.

INTEGRATION - Provision in a pension plan which relates plan contributions and/or benefits to those of a government pension program, e.g. Canada Pension Plan.

INTEREST ASSUMPTION - The actuarial assumption as to the return to be earned on funds invested, or to be invested, to provide for future pension benefits. In calling the return interest, it is recognized that, in addition to interest on debt securities, the earnings of a pension fund may include items such as dividends on equity securities, rentals on real estate, realized and unrealized gains or (as offsets) losses on fund investments. The actuary uses the interest assumption to discount future liabilities to calculate their present value.

INVESTMENT MANAGEMENT - The management of a pension fund's investments; consists of two parts - the formulation of investment policy and the implementation of this policy.

INVESTMENT POLICY - The level of risk the pension fund governors are prepared to assume; it is most often expressed as an asset mix policy and a financial rate of return goal.

INVESTMENT RETURN (YIELD) - Actual earnings of a pension fund including interest on fixed income securities (bonds, mortgages, etc.) dividends, capital gains, etc., normally expressed as a percentage of assets.

INVESTMENT RISK SURPLUS - The difference between the actual investment return and the investment return that would have resulted if the pension fund governors had selected an investment policy that was essentially risk free.

LIQUIDITY - Refers to the ease with which an investment can be converted to cash or near-cash. For example, publicly-traded stocks are very liquid while real estate is less so.

MARKET INVESTMENTS - Assets that can be bought and sold in a secondary market. They include highly liquid assets such as stocks and bonds, and less liquid assets such as real estate, mortgages, venture capital and private placements.

MARKET VALUE - The value of an asset set in the marketplace, given a willing buyer and a willing seller.

MONEY PURCHASE PLAN - See Defined Contribution Plan.

MULTI-EMPLOYER PLAN - A pension plan covering employees of more than one employer, usually by agreement with a union or group of unions and usually offering a defined contribution plan converted to a defined benefit on retirement. Note that OMERS and HOOPP are multi-employer plans of another type; they are not tied to a union and offer a defined benefit plan.

NON-CONTRIBUTORY PLAN - A pension plan in which all required contributions are made by the employer.

NON-MARKET GOVERNMENT DEBT - Refers to investments of certain pension funds in government debt with specified terms. Whether held as debentures or as book entries, such debt may not be bought or sold in a secondary market.

OLD AGE SECURITY (OAS) - Federal program providing a universal, flat rate pension to all residents aged 65 and over, regardless of need; also provides income-tested supplements.

PAY-AS-YOU-GO PLAN - Term used for benefits that are not funded except when paid to individuals, i.e. payment is made from current revenue or other sources outside the plan as such (also known as Pay-Go Plan). A modified pay-as-you-go plan has a small fund but is not fully funded.

PENSION - Generally, any regular periodic payment to a person who has retired from the service of an employer or has met certain age or other conditions for payments under a government pension program.

PENSION BOARD (COMMITTEE) - Group of persons designated according to the terms of a pension plan to oversee various administrative functions. Members may be trustees of the fund.

PENSION COMMISSION OF ONTARIO - Commission responsible for administering the Ontario Pension Benefits Act.

PENSION DEAL - The statement of the pension promise by an employer to an employee and the means by which that promise will be fulfilled.

PENSION FUND - The assets which are accumulated and held separately in order to pay for the pension benefits promised.

PENSION FUND GOVERNORS OR TRUSTEES - The persons who have overall responsibility for, and decision-making powers in respect of, a pension fund.

PENSION PLAN - A plan organized and administered to provide a regular income for the lifetime of retired members; other benefits that may be provided include payments on permanent disability, death, etc.

PLAN MEMBER - A contributor to a pension fund (active member), a recipient of a pension (retiree/beneficiary) or a person who is no longer contributing but is entitled to a pension in the future (deferred member).

PLAN TERMINATION - Discontinuance of an employment pension plan, voluntary or involuntary (e.g. as in bankruptcy); wind-up procedure regulated by pension benefits legislation.

POOLED FUND - Assets of two or more pension plans, held by pension investment organization and combined for investment purposes in a single fund, each plan sharing pro rata in the net income from investments.

PORTABILITY - Extent to which an individual is provided on retirement with pension income which recognizes all periods of employment with various employers.

PORTFOLIO - The collection of investments held by a pension fund.

PRESENT VALUE - Amount of money that, if invested today at a given rate of compound interest would provide a defined benefit commencing at a specified future date.

PRIVATE SECTOR PENSION PLAN - An employment pension plan offered by an employer or by employers and unions (multi-employer plan) in the private sector.

PUBLIC SECTOR PENSION PLAN - Pension plans covering employees of governments and public agencies but does not include the Canada Pension Plan.

RATE OF RETURN - The investment yield (return) from investments of a pension fund, including interest on fixed income securities, dividends, capital gains, etc.

REGISTERED RETIREMENT SAVINGS PLAN (RRSP) - A personal retirement savings plan, defined in the Income Tax Act, under which tax is deferred on contributions and investment income until received as annuity payments.

RETIREMENT - Withdrawal from the active work force because of age; may also be used in the sense of permanent withdrawal from the labour force for any reason, including disability.

RISK - Five kinds which are important to pension fund are:

Default Risk - The risk that investments held by a pension fund will go into default; for example, that the issuer of a bond will not pay the principal and interest when it is due.

Market Volatility Risk - The risk associated with variations in the market value of investments. The market volatility risk of a portfolio can be reduced by diversifying among different types of investments, different industries, regions, etc.

Inflation Risk - Inflation risk refers to the impact that unanticipated inflation can have on the market values of investments relative to the liabilities of the pension fund.

Liquidity Risk - Liquidity risk reflects the cost of being unable to react to either anticipated or unanticipated circumstances which would require investments being converted to cash or near cash.

Independent Return Risk - The risk that the liabilities of the pension fund will change in ways that do not match the investments.

SHARED RISK/SHARED REWARD PLAN - A type of pension plan in which the burden of a deficit and the advantage of a surplus both are shared by plan members and the employer, normally by varying contribution rates, varying benefit improvements, or similar means. This type of plan combines elements of defined benefit related and asset related plans.

SOCIAL INVESTING - Refers to adopting social or ethical goals in addition to the rate of return objective in pension fund investing. May or may not entail accepting a lower, or concessionary rate of return. *(See also Economic Enhancement)*

SURPLUS - An amount determined by an actuary when the present value of estimated future pension liabilities is less than current assets of the pension fund. *(See also Actuarial Surplus and Investment Risk Surplus).*

TAX DEFERRAL - Provision in the income tax act whereby certain pension and similar contributions are tax-deductible and employer contributions and investment income are not included in a member's current taxable income; but benefit payments are considered income for tax purposes in the year in which they are received.

TEN PER CENT FOREIGN INVESTMENT RULE - The income tax act requires that no more than 10 per cent of pension fund assets be in foreign property to qualify for tax-free treatment.

TRUST AGREEMENT - An agreement setting out the duties and responsibilities of a trustee or trustees under a pension plan.

TRUSTEED PENSION PLAN - An employment pension plan whose funds are held and normally invested by trustees, and the plan sponsor is responsible for making sufficient contributions to maintain the plan's solvency.

UNFUNDED LIABILITY (UNFUNDED ACTUARIAL LIABILITY) - Generally, any amount by which the assets of a pension plan are less than its liabilities. Sometimes used to refer to a situation when the liability is due to the cost of improved benefits.

VESTING - The right of an employee to a part, or to all, of his or her accrued pension on termination of employment; usually requires locking-in of employee's contributions.

WINDING-UP (OR WIND-UP) - See Plan Termination

YEAR'S MAXIMUM PENSIONABLE EARNINGS (YMPE) - Term used in Canada Pension Plan, often referred to as the earnings ceiling; the maximum amount of annual earnings from employment on which CPP contributions and benefits are calculated. YMPE is calculated each year according to a formula related to average industrial wage level.